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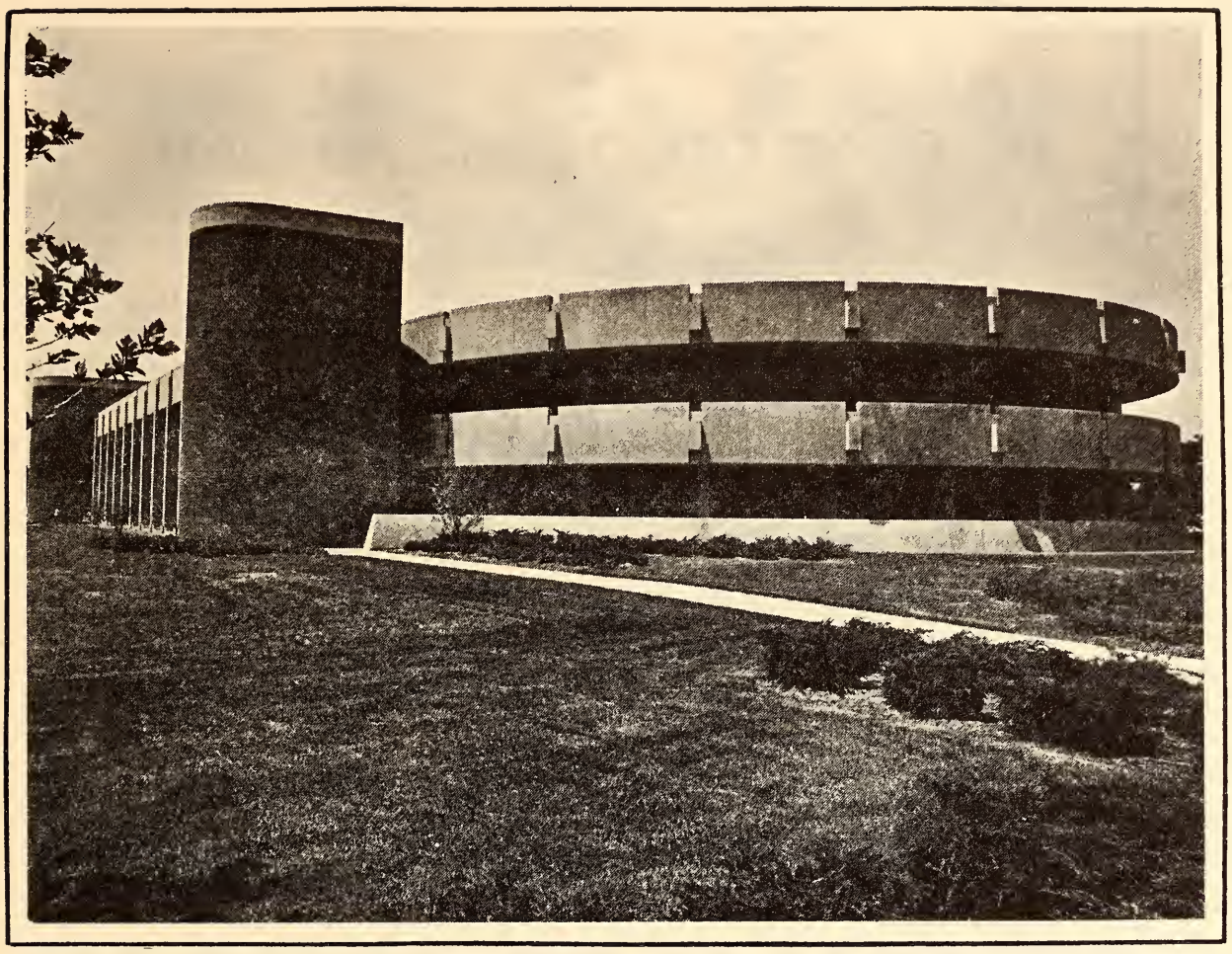

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Pornography as Group Libel: the Indianapolis Sex Discrimination Ordinance

William E. Brigman*

Pornography is a discriminatory practice based on sex which denies women equal opportunities in society. Pornography is central in creating and maintaining sex as a basis for discrimination. Pornography is a systematic practice of exploitation and subordination based on sex which differentially harms women. The bigotry and contempt it promotes, with the acts of aggression it fosters, harm women's opportunities for equality of rights in employment, education, access to and use of public accommodations, and acquisition of real property; promote rape, battery, child abuse, kidnapping and prostitution and inhibit just enforcement of laws against such acts; and contribute significantly to restricting women in particular from full exercise of citizenship and participation in public life, including in neighborhoods.[1]

I. Introduction

It is a common assertion of many feminists that the display of women's bodies, whether in advertisements for jeans or in hardcore pornography, not only leads to violence against women, but also constitutes a form of class or group libel.[2] Despite the argument espoused by many feminists,

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[1]Indianapolis, Ind., Code of Indianapolis and Marion County, Indiana § 16-1(a)(2) (1984)

[2]Gloria Steinem's statement of the position is archetypal:

> [O]ur bodies have too often been the objects of pornography and the woman-hating, violent practices that it preaches. Consider also our spirits that break a little each time that we see ourselves in chains on full labial display for the conquering male viewer, bruised or on our knees screaming a real or pretended pain to delight the sadist, pretending to enjoy what we don't enjoy, to be blind to the images of our sisters that really haunt us—humiliated often enough ourselves by the truly obscene idea that sex and the domination of women must be combined.

Steinem, *Erotica and Pornography: A Clear and Present Difference*, Ms. Magazine, Nov. 1978, at 78. A similar argument is made by Susan Brownmiller. *See* S. Brownmiller,

that pornography degrades and debases females through its portrayals,[3] there have been very few attempts to develop a doctrinal case that pornography is "group libel."[4]

On May 1, 1984, however, the City of Indianapolis, Indiana adopted an ordinance[5] that appears to be based on an assumption that pornography is group libel and leads to violence against females.[6] This ordinance does

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AGAINST OUR WILL: MEN, WOMEN AND RAPE, 394 (1975). *See also infra* notes 3-4 and accompanying text.

[3]S. BROWNMILLER, *supra* note 2, at 394. *See also* S. GRIFFIN, PORNOGRAPHY & SILENCE: CULTURE'S REVENGE AGAINST NATURE (1981); Morgan, *How to Run the Pornographers Out of Town (And Preserve the First Amendment)*, MS. MAGAZINE, Nov. 1978, at 55; *Violent Pornography: Degradation of Women versus Rights of Free Speech*, 8 N.Y.U. REV. L. & SOC. CHANGE 181 (1979).

The terms "feminist," "feminist argument," "feminist position," and the like are used throughout this Article to distinguish the particular antipornography views of women's rights activists from the more traditional antipornography views of conservatives. The traditional conservative argument is that pornography degrades the human race by "de-individualizing and dehumanizing sex acts." E. VAN DEN HAAG, CENSORSHIP: FOR AND AGAINST, 146-47 (H. Hart ed. 1971). Arguably, "dehumanization" causes people to treat one another merely as objects and means. This eventually leads to the regression of people to an animal state, and diminishes the specialness of human life. *Id.* The feminist position views pornography as directed primarily against women, and many feminists view it as inherently violent. Pornography which is not overtly violent is still implicitly violent because it teaches men to view women as *things*, rather than as human beings, leading ultimately to sexism, rape, and other forms of sexual violence.

Feminists are not monolith in their views. *See, e.g.*, JAGGER & STRUHL, FEMINIST FRAMEWORKS (1978) (discussing the different views among feminists). There is, however, very widespread agreement that pornography is both a cause and a symptom of sexism and violence against women.

[4]In its original formulation, "A group libel law [was] a statute making it a criminal offense to portray . . . certain groups in a way which [would] (a) incite the general population to hate, ridicule and disparage that group, and/or (b) present a danger of breach of the peace." *See* Beth, *Group Libel and Free Speech*, 39 MINN. L. REV. 167, 167 (1955). *See also infra* text accompanying note 30.

No works have been found by this author that specifically refer to pornography as group libel. However, at least one author has developed an analogy between obscenity and racial insults. Delgado, *Words that Wound: A Tort Action for Racial Insults, Epithets, and Name-Calling*, 17 HARV. C.R.-C.L. L. REV. 133 (1982). *See also* Bryant, *Sexual Display of Women's Bodies—A Violation of Privacy,* 10 GOLDEN GATE 1211 (1980).

[5]*See* General Ordinance No. 35, INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA Ch. 16 (1984). On November 19, 1984, this ordinance was declared unconstitutional by Federal District Court Judge Sarah Evans Barker in American Booksellers Ass'n Inc. v. Hudnut, 598 F. Supp. 1316 (S.D. Ind. 1984). This Article refers to the *American Booksellers* opinion where the Author's analysis coincides with the court's conclusions. This Article does not, however, attempt to serve as an analysis of the *American Booksellers* opinion. The district court held that the ordinance, by defining what it viewed as pornography, "sought to regulate expression, that is, to suppress speech. And although the State has a recognized interest in prohibiting sex discrimination, that interest does not outweigh the constitutionally protected interest of free speech." *Id.* at 1342. Therefore, the ordinance was held unconstitutional. As of publication, the district court's *American Booksellers* decision is on appeal to the Seventh Circuit Court of Appeals. American Booksellers v. Hudnut, No. 84-3147 (7th Cir. Dec. 21, 1984).

[6]*See supra* notes 3-4. Opponents of pornography consider neither obscenity laws of the type upheld by the United States Supreme Court in Miller v. California, 413 U.S.

not specifically define pornography as group libel. Rather, it refers to pornography as a discriminatory practice against women, violating the civil rights of females.[7] Yet clearly, the law also qualifies as a group libel law, in that it punishes individuals for the display of materials which portray a group in a way that at least some members of the group find offensive.[8]

The ordinance is an attempt to expand the concept of sexual harassment in the workplace—a concept accepted by the Equal Opportunities Commission and the courts—to society as a whole. An assumption underlying the ordinance is that pornography is sexual harassment and can be outlawed, as is sexual harassment forced on a female in the workplace.[9] As such, it is in conflict with the philosophy underlying the United States Supreme Court's decisions regarding first amendment and obscenity issues: speech may not be punished or limited merely because it offends,[10] and that the beholder of such objectionable material has the option of averting his eye to avoid exposure.[11]

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15 (1973), nor the zoning laws of the type upheld in Young v. American Mini Theatres, 427 U.S. 50 (1976), to be adequate safeguards for two reasons. First, *Miller* only reaches "hardcore" pornography and does not include violence in its definition. *See infra* notes 126-28 & 135. Second, "[z]oning statutes do not ban pornography; they merely contain it." *Violent Pornography and the First Amendment: A Dialogue*, 8 N.Y.U. REV. L. & SOC. CHANGE 187, 196 (1979).

Because of dissatisfaction with traditional obscenity law approaches, a new approach based on the concept of sex discrimination was developed by women's rights activists in Minneapolis. However, their movement was stymied when Mayor Donald Fraser vetoed the ordinance on the grounds that it was unconstitutional. N.Y. Times, Jan. 6, 1984, § 1, at 11, col. 1.

[7]INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA §§ 16-1(a)(2); -3(g)(4), (5), & (6). Specifically, pornography is defined as "the graphic sexually explicit subordination of women." *Id.* at § 16-3(q).

[8]*See infra* notes 30-38.

[9]The history of the Indianapolis ordinance supports the argument that it is an attempt to broaden the workplace analogy to include society-at-large. The Indianapolis ordinance grew out of an ordinance written in Minneapolis by both Catherine MacKinnon, a law professor specializing in sexual discrimination in the workplace, and Andrea Dworkin, a visiting professor at the University of Minnesota. N.Y. Times, Jan. 6, 1984, § 1, at 11, col. 1.

The analogy between the workplace is based on the perceived unavoidable nature of exposure and harassment in both situations. The Equal Employment Opportunity Commission's (EEOC) *Guidelines on Discrimination Because of Sex* uses the presumption of a "captive" female audience to hold employers responsible for sexual harassment by employees. 29 C.F.R. § 1604.11 (1984). While not specifically referring to the workplace analogy, feminists argue that pornography is inescapable in modern society, using a captive audience argument similar to the EEOC's position. *See* S. GRIFFIN, *supra* note 3, and A. DWORKIN, PORNOGRAPHY/MEN POSSESSING WOMEN (1981).

[10]*See* Collin v. Smith, 447 F. Supp. 676, 697 (N.D. Ill.), *aff'd*, 578 F.2d 1197 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978) and cases cited therein. *See also infra* notes 123-28.

[11]*See* Miller v. California, 413 U.S. 15 (establishing a three-prong test for obscene materials); Erznoznik v. Jacksonville, 422 U.S. 205, 208-12 (1975) (setting forth the concept of the avertable eye). A feminist response to the Court's concept of the avertable eye is that pornography and its effects are so pervasive in the society that they cannot be avoided, and therefore must be controlled. *See also supra* note 3.

Under the Indianapolis ordinance,[12] any woman who feels aggrieved by a piece of pornography[13] can file a complaint with the city's Office of Equal Opportunity (OEO).[14] After a finding that the material meets the criteria of the ordinance, the OEO may seek court review of its findings. If upheld, a temporary injunction may be issued to the purveyor of the material pending resolution of the complaint by the OEO.[15] Violation of such an order, however, would carry a civil rather than a criminal penalty.

Immediately upon its enactment, the Indianapolis ordinance was found unconstitutional on first amendment grounds in *American Booksellers Association, Inc. v. Hudnut*.[16] The ordinance, by casting an antipornography law in the guise of a civil rights law, is an innovative attempt to circumvent the limitations of the law of obscenity,[17] while gaining societal and legal acceptance for a feminist concept of pornography. In addition, it is an ingenious way to avoid many of the problems that have plagued attempts to outlaw pornography as a form of group libel.

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[12]The Indianapolis ordinance reads in pertinent part:

> Pornography shall mean the graphic sexually explicit subordination of women, whether in pictures or in words, that also includes one or more of the following:
>
> (1) Women are presented as sexual objects who enjoy pain or humiliation; or
>
> (2) Women are presented as sexual objects who experience sexual pleasure in being raped; or
>
> (3) Women are presented as sexual objects tied up or cut up or mutilated or bruised or physically hurt, or as dismembered or truncated or fragmented or severed into body parts; or
>
> (4) Women are presented being penetrated by objects or animals; or
>
> (5) Women are presented in scenarios of degredation, injury, abusement, torture, shown as filthy or inferior, bleeding, bruised, or hurt in a context that makes these conditions sexual; and
>
> (6) Women are presented as sexual objects for domination, conquest, violation, exploitation, possession, or use, or through postures or positions of servility or submission or display.
>
> The use of men, children, or transsexuals in the place of women in paragraphs (1) through (6) above shall also constitute pornography under this section.

INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(q) (1984).

[13]*Id.* §§ 16-4 to -17 [the Office of Equal Opportunity shall hereinafter be referred to as the OEO].

[14]*Id.* § 16-27(c).

[15]Section 16-26(d) provides in part that:

> [T]he committee may cause to be served on the respondent an order requiring the respondent to cease and desist from the unlawful discriminatory practice and requiring such person to take further affirmative action as will effectuate the purposes of this chapter, including but not limited to the power to restore complainant's losses incurred as a result of discriminatory treatment, as the committee may deem necessary to assure justice; . . . .

Id. at § 16-26(d). Court enforcement of the orders is provided after a *de novo* determination of sexual discrimination. *Id.* at §§ 16-27.

[16]598 F. Supp. 1316 (S.D. Ind. 1984).

[17]*See supra* note 11 and *infra* note 19.

If such an approach were ever upheld by the courts, it would have an impact in many areas of the law. First, such a holding would resurrect, in a new guise, the concept of thematic obscenity which the Supreme Court rejected in 1959.[18] Second, such an approach would circumvent the Supreme Court's guidelines for defining obscenity,[19] thereby allowing the proscription of materials which are not necessarily obscene. Third, the ordinance presents a confrontation with the Supreme Court's concept of the avertable eye by contending that the effects of pornography are so pervasive that they are inescapable.[20] Fourth, by statutorily determining that pornography is, in essence, "group libel" against women,[21] the civil rights approach allows its proponents to avoid proving the validity of such claims as pornography differentially harms women, promotes bigotry or contempt of women, or fosters acts of aggression against females.[22] All that is required under the ordinance is a finding that the material meets the ordinance's definition of pornography.[23] Fifth, the approach incorporated by the ordinance avoids the decision of the United States Supreme Court in *Stanley v. Georgia*,[24] which permitted the use of "obscene" materials in the privacy of one's own home.[25] And finally, in theory, the ordinance makes the politically responsive Office of Equal Opportunity into a censorship board.[26]

One important question posed by the feminist argument and the Indianapolis ordinance is the extent to which nonobscene material can be proscribed without violating the free speech and press guarantees of

---

[18]*See* Kingsley Int'l Pictures Corp. v. Regents, 360 U.S. 684 (1959).

[19]The basic guidelines for the trier of fact must be: (a) whether "the average person, applying contemporary community standards" would find that the work, taken as a whole, appeals to the prurient interest . . .; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value.

Miller v. California, 413 U.S. 15, 24 (1972) (citations omitted).

[20]"The ability of government, consonant with the Constitution, to shut off discourse solely to protect others from hearing it is, in other words, dependent upon a showing that substantial privacy interests are being invaded in an essentially intolerable manner." Cohen v. California, 403 U.S. 15, 21 (1971). Absent such circumstances, it is generally the viewer's duty to "avoid further bombardment of their sensibilities simply by averting their eyes." *Id.*

[21]*See supra* notes 1-8 and accompanying text.

[22]Generally, political lawmaking bodies do not require the type of proof of harm that would normally be required in a court of law. The procedure set up by the Indianapolis ordinance, which resembles a civil rights action, requires less than a court of law might require in a suit alleging pornography. Legislatures, although they are not required to prove the assumptions on which they act, are generally required to exercise greater caution in areas dealing with freedom of speech, than in other legislative matters. United States v. Carolene Products Co., 304 U.S. 144, 152 n.4 (1938).

[23]INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-15 (1984). *See also supra* note 12.

[24]394 U.S. 557 (1969).

[25]*Id.* at 568.

[26]*See supra* notes 12-15 and accompanying text.

the first amendment. The purpose and effect of the new civil ordinance was not to replace and/or supplement the present criminal procedures for regulating obscenity, nor would its enforcers be bound by the criminal substantive law or procedures. Rather, it was designed as a civil statute that treats pornography as a form of discrimination. As such, the ordinance presented major constitutional issues.

This Article will first examine the constitutional status of criminal group libel laws, of the type upheld in *Beauharnais v. Illinois*,[27] and its implication for civil group libel laws.[28] It will then review the other areas of constitutional deficiency within the ordinance, and focus on whether or not a hybrid group libel law could ever stand up to constitutional scrutiny.[29] Before one can fully understand the role that criminal group libel laws play in determining the constitutionality of an ordinance like the one in Indianapolis, however, it is important to review the theories that have shaped the development of both group libel laws and the law of obscenity.

II. The Concept of Group Libel

A. Introduction

Underlying group libel laws is a theory that an individual derives a sense of worth from his community. "[P]articipation in groups . . . contribute to [an individual's] . . . social welfare and develop[s] [one's] individual capacities. Hence, defamatory attacks on groups are attacks both on the pluralistic forces which make up a democratic society and derivatively on the individual members whose own status derives from their group affiliations."[30]

This theory forms a basis for both civil and criminal laws aimed at controlling group libel. However, group libel laws are by definition a restriction on the freedom of discussion; hence, courts have been extremely reluctant to endorse them.[31]

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[27]343 U.S. 250 (1952).

[28]*See infra* notes 30-114 and accompanying text.

[29]*See infra* notes 115-60.

[30]Reisman, *Democracy and Defamation: Control of Group Libel,* 42 Colum. L. Rev. 727, 731 (1942). In his seminal article on group libel, Reisman stated the classic case for group defamation laws:

> The role assigned to individual honor in a community's scheme of values, the character of the groups whose reputation is safeguarded, and the type of protective measures taken are important indications of the community's cultural level and democratic quality. It is only through strengthening the protection of the groups to which an individual belongs that his own values and his own reputation can be adequately safeguarded. The isolated person is as helpless in the face of systematic defamation by opposing groups . . . as in the face of concerted economic power. In the political as in the economic struggle, modern democracy operates through the interplay of group activities . . . .

Id.

[31]Recent statements indicate that group libel laws of the type upheld in Beauharnais v. Illinois, 343 U.S. 250 (1952), may be unconstitutional. Collin v. Smith, 578 F.2d 1197, 1205 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978); Tollett v. United States, 485 F.2d 1087, 1094 n.14 (8th Cir. 1973); Anti-Defamation League of B'nai B'rith v. F.C.C. 403 F.2d 169, 174, n.5 (D.C. Cir.) (Wright, J., concurring), *cert. denied*, 394 U.S. 930 (1968).

In the past, two approaches to group libel have been used: incidental protection of groups, and members of groups, through standard libel law and, criminal group libel laws.[32] The standard law of libel was developed to protect the individual, or identifiable members of small groups who had been defamed. Thus, this approach offered only a limited civil remedy for group defamation. For example, one basic principle underlying this area is that defamation of a large nonincorporated group ("class" is a less commonly used, but more accurate term) does not give rise to a civil action by the group. Another is that defamation of a large group does not give rise to a civil action by an individual group member, unless the member can show special application of the defamatory material to himself of herself.[33]

Because of these limitations in the civil law, the concept of criminal group libel was developed in the early part of this century.[34] These new laws were based on a "fighting words" rationale, that is, words which resulted in disturbances of the peace.[35] There were earlier state cases sustaining group libel laws,[36] yet *Beauharnais v. Illinois*[37] was the first group libel case ever to reach the United States Supreme Court. Therefore, despite questions as to its continuing legal validity,[38] it has never been explicitly overruled and is the starting point for any discussion of group libel.

B. Beauharnais v. Illinois[39]

Joseph Beauharnais was the president of the White Circle League of America, Inc. In January, 1950, he organized and directed a group of

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[32]*See, e.g.*, Beauharnais v. Illinois, 343 U.S. 250 (1952). *See infra* notes 39-64.

[33]For a discussion of the law of defamation, see L. ELDREDGE, LAW OF DEFAMATION (1978); W. PROSSER, HANDBOOK OF THE LAW OF TORTS (4th ed. 1971); Tanenhaus, *Group Libel*, 35 CORNELL L. REV. 61 (1950) (tracing the historical antecedents of group libel laws in England and America); Note, *The History and Theory of the Law of Defamation*, 3 COLUM. L. REV. 546 (1904). *See also* Lewis, *The Individual Member's Right to Recover for a Defamation Leveled at the Group*, 17 U. MIAMI L. REV. 519 (1963). For a demonstration of the rules in action, see Neiman-Marcus v. Lait, 13 F.R.D. 311 (S.D.N.Y. 1952).

[34]Tanenhaus, *supra* note 33, at 268-72.

[35]Chaplinsky v. New Hampshire, 315 U.S. 568 (1942). In *Chaplinsky*, the Court stated:

> There are certain well-defined and narrowly limited classes of speech, the prevention and punishment of which have never been thought to raise any Constitutional problem. These include the lewd and obscene, the profane, the libelous, and the insulting or "fighting" words—those which by their very utterance inflict injury or tend to incite an immediate breach of the peace.

Id. at 571-72 (footnotes omitted).

[36]*See* People v. Turner, 28 Cal. App. 766, 154 P.2d 34 (1915); Alumbaugh v. State, 39 Ga. App. 559, 147 S.E. 714 (1929); People v. Speilman, 318 Ill. 482, 149 N.E. 466 (1925); Crane v. State, 14 Okla. Crim. 30, 166 P. 1110 (1917).

[37]343 U.S. 250 (1952).

[38]New York Times Co. v. Sullivan, 376 U.S. 254 (1964). *See also* Collin v. Smith, 578 F.2d 1197, 1205 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978).

[39]343 U.S. 250 (1952). For a similar discussion of this case and changes in the concept of group libel, see the district court opinion in Collin v. Smith, 447 F. Supp. 676 (N.D. Ill.), *aff'd*, 578 F.2d 1197 (7th Cir. 1978).

volunteers who distributed leaflets on street corners in downtown Chicago. The handbills, cast in the form of a petition to the Mayor and City Council, called upon the city " 'to halt the further encroachment, harassment and invasion of white people, their property, neighborhoods and persons, by the Negro—through the exercise of the Police Power.' "[40] The leaflet urged the white people of the city to resist the civil rights programs and called upon " 'all normal white people' " to join the battle against blacks.[41] Beauharnais was arrested under a section of the Illinois Criminal Code[42] that made it unlawful to publish anything portraying a class of citizens as lacking in virtue or other such thing which might induce a breach of the peace. As a defense, Beauharnais offered to prove the truth of his statement with testimony explaining that black residential areas had high crime rates, and that an area's property values actually did decrease when blacks become residents.[43] At the time of this opinion, Illinois recognized the truth as a general defense in such actions. To succeed, one had to show not only that the utterance stated the facts, but also that the publication was made " 'with good motives and for justifiable ends.' "[44] The latter part of the test could not be met, and therefore the trial judge sustained an objection to this offer of proof, also finding that the statute was not an unconstitutional restriction of free speech.[45]

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[40]343 U.S. at 276 (quoting the leaflet)(Appendix to Opinion of Black, J., dissenting). The leaflet, which contained an application for membership in the White Circle League, urged " 'ONE MILLION SELF RESPECTING WHITE PEOPLE IN CHICAGO TO UNITE UNDER THE BANNER OF THE WHITE CIRCLE LEAGUE . . . [to resist] TRUMAN'S INFAMOUS CIVIL RIGHTS PROGRAM and many Pro Negro Organizations to amalgamate the black and white races with the object of mongrelizing the white race.' " *Id.* (Appendix to Opinion of Black, J., dissenting) (quoting the leaflet). It further stated that " '[i]f persuasion and the need to prevent the white race from becoming mongrelized by the negro will not unite us, then the aggressions . . . rapes, robberies, knives, guns and marijuana of the negro, SURELY WILL.' " *Id.* (quoting the leaflet). The leaflet ended with a declaration that " '[T]HE FIRST LOYALTY OF EVERY WHITE PERSON IS TO HIS RACE. . . . THE HOUR HAS STRUCK FOR ALL NORMAL WHITE PEOPLE TO STAND UP AND FIGHT . . . .' " *Id.* (quoting the leaflet).

[41]*Id.* (quoting the leaflet).

[42]The statute read:

> It shall be unlawful for any person, firm or corporation to manufacture, sell, or offer for sale, advertise or publish, present or exhibit in any public place in this state any lithograph, moving picture, play, drama or sketch, which publication or exhibition portrays depravity, criminality, unchastity, or lack of virtue of a class of citizens, of any race, color, creed or religion which said publication or exhibition exposes the citizens of any race, color, creed or religion to contempt, derision, or obloquy or which is productive of breach of the peace or riots . . . .

ILL. REV. STAT. ch. 38, § 471 (1950).

[43]343 U.S. at 266 n.21.

[44]*Id.* at 265 (quoting ILL. CONST., Art. II, § 4)(footnote omitted). *See also* 343 U.S. at 254 n.1.

[45]343 U.S. at 254. The Illinois Supreme Court agreed with the trial judge's action. It determined that such evidence went only to the truthfulness of Beauharnais' statements, and did not prove that the publication was made with good motives or for justifiable ends. Yet under the Illinois statute, truth alone was not a defense. *See supra* note 43 and accompanying text.

The court took note of the clear and present danger test but did not apply it,[46] finding the leaflet libelous as a matter of law. Thus, the jury was restricted to the narrow factual question of whether Beauharnais was in fact guilty of manufacturing, publishing, or distributing the leaflets, as proscribed by the statute.[47] Under these rulings, Beauharnais was convicted and fined $200.[48]

The Supreme Court of Illinois sustained the conviction on the grounds that truth alone was not a defense against a charge of criminal libel. It was necessary to prove the item was published " 'with good motives and for justifiable ends.' "[49] Beauharnais, however, had not made an offer of proof of either, and the court doubted that he could in view of the scurrilous nature of the leaflet. Therefore, the court concluded that the trial judge's refusal to accept Beauharnais' evidence was not in error, and the statute was upheld based on a "fighting words" rationale.[50]

On appeal to the Supreme Court of the United States, Beauharnais attacked the Illinois statute as being too vague to meet the tests of the due process clause. He also argued that the statute violated the first amendment protections of freedom of speech and press.[51] Justice Frankfurter, writing for a five-man majority, easily disposed of the vagueness argument. He recited a fifty-year history of racial violence in Illinois to show that the state legislature was dealing with more than just an abstract issue when it drafted the criminal statute. Moreover, he found the statute clear, both in its drafting and application.[52]

The central issue before the Court was the legitimacy of group libel laws, or rather, whether or not the fourteenth amendment prevents states from punishing such libels.[53] Justice Frankfurter noted that just as a state could have an interest in sanctioning libelous statements made to individuals, so too could that state have an interest in preventing such statements from being directed at a group. The Court felt that unless such laws were without purpose or relation to the well-being of the state, it could not

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[46]The Illinois Supreme Court in People v. Beauharnais, 408 Ill. 512, 517-18, 97 N.E.2d 343, 346 (1951), quoted the original statement of the "clear and present danger" test from Schenck v. U.S., 249 U.S. 47 (1919). "The question in every case is whether the words used are used in such circumstances and are of such a nature as to create a clear and present danger that they will bring about the substantive evils that Congress has a right to prevent." *Id.* at 52 (quoted in People v. Beauharnais, 408 Ill. at 517, 97 N.E.2d at 346). The Illinois Supreme Court concluded that "[a]ny ordinary person could only conclude from the libelous character of the language that a clash and riots would eventually result between the members of the White Circle League of America and the Negro race." 408 Ill. at 517, 97 N.E.2d at 346.

[47]343 U.S. 250, 254.

[48]*Id.* at 251.

[49]408 Ill. at 518, 97 N.E.2d at 346 (quoting ILL. REV. STAT. ch. 38 § 404 (1949)). *See also supra* note 43.

[50]408 Ill. at 517-18, 97 N.E.2d at 347.

[51]343 U.S. at 251-52.

[52]*Id.* at 257-64.

[53]*Id.* at 252.

preclude a state from prohibiting such language.[54] Refusing to pass on the wisdom of the Illinois statute, the Supreme Court determined that nothing in the United States Constitution precluded Illinois from passing such a law, and affirmed the conviction.[55]

The most important dissent was that of Justice Black. He argued that a group libel law such as the Illinois statute could not be fitted into the traditional pattern of criminal libel laws, pointing out that hitherto the *crime* had punished only "false, malicious, scurrilous charges against *individuals*, not against huge groups."[56] Justice Black believed that the expansion of criminal laws beyond demonstrable *individual* injuries made the charge of libel so vague that it was nothing more than an arbitrary basis

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[54]Justice Frankfurter's majority opinion stated:

> No one will gainsay that it is libelous falsely to charge another with being a rapist, robber, carrier of knives and guns, and user of marijuana. The precise question before us, then, is whether [the 14th amendment] prevents a State from punishing such libels—as criminal libel has been defined, limited and constitutionally recognized time out of mind—directed at designated collectivities and flagrantly disseminated. . . . We cannot say . . . that the question is concluded by history and practice. But if an utterance directed at an individual may be the object of criminal sanctions, we cannot deny to a State power to punish the same utterance directed at a defined group, unless we can say that this is a wilful and purposeless restriction unrelated to the peace and well-being of the State.
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> Illinois . . . [could] conclude that wilful purveyors of falsehood concerning racial and religious groups promote strife and tend powerfully to obstruct the manifold adjustments required for free, ordered life in a metropolitan, polyglot community. . . .
>
> In the face of . . . history and its frequent obligato of extreme racial and religious propaganda, we would deny experience to say that the Illinois legislature was without reason in seeking ways to curb false or malicious defamation of racial and religious groups, made in public places and by means calculated to have a powerful emotional impact on those to whom it is presented. . . .
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> . . . .
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> [W]e are precluded from saying that speech concededly punishable when immediately directed at individuals cannot be outlawed if directed at groups with whose position and esteem in society the affiliated individual may be inextricably involved.

Id. at 257-63. The Court went on to note that because the libelous language was not protected by the first amendment, it was unnecessary, either for [the Supreme Court] or for the State courts, to consider the issues behind the phrase "clear and present danger." Certainly no one would contend that obscene speech, for example, may be punished only upon a showing of such circumstances. Libel, as we have seen, is in the same class. *Id.* at 266.

[55]343 U.S. at 266-67.

[56]*Id.* at 271-72 (Black, J., dissenting) (emphasis added). Justice Black noted:

> This limited scope of the law of criminal libel is of no small importance. It has confined state punishment of speech and expression to the narrowest of areas involving nothing more than purely private feuds. Every expansion of the law of criminal libel so as to punish discussions of matters of public concern means a corresponding invasion of the area dedicated to free expression by the First Amendment.

Id. at 272.

for limiting speech critical of certain groups. Noting that Beauharnais was simply "making a genuine effort to petition [his] elected representatives,"[57] Justice Black explained that the effect of the *Beauharnais* decision was to make it "very dangerous indeed to say something critical of [a group]"[58] when "arguing for or against the enactment of laws that may differently affect [that group]."[59]

There is little doubt that group libel laws, whether or not they can be fitted into the traditional criminal libel law pattern,[60] do cause serious constitutional concerns, for they are restrictions on free discussion. In this specific case, Beauharnais was circulating his leaflets as part of a campaign to secure legislation, albeit legislation which would have been unconstitutional if enacted.[61] As Justice Jackson pointed out in his dissent, under the challenged law there was no requirement

> to find any injury to any person, or group, or to the public peace, nor to find any probability, let alone any clear and present danger, of injury to any of these. . . .
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> . . .
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> The leaflet was simply held punishable as criminal libel *per se* irrespective of its actual or probable consequences.[62]

Constitutional concerns over such a *per se* treatment make the validity of *Beauharnais* highly doubtful today. It has never been used as precedent in a Supreme Court decision; rather, "the views of [Justice] Black . . . to a great extent have prevailed in later cases."[63] At least three federal courts of appeal have stated in dicta that it is doubtful whether the case is still good law.[64]

C. *The Continuing Validity of Group Libel Laws and* Beauharnais v. Illinois

Since the *Beauharnais* decision, the standards used by the courts to determine the validity of state restrictions on the freedoms of speech and press have changed in three distinct ways. First, the incorporation of the provisions of the first amendment into the fourteenth amendment is now

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[57]*Id.* at 267 (Black, J., dissenting).

[58]*Id.* at 273 (Black, J., dissenting).

[59]*Id.* (Black, J., dissenting).

[60]*See* Note, *Constitutional Law: Validity of Group Libel Laws*: Beauharnais v. Illinois, *343 U.S. 250 (1952)*, 38 CORNELL L. REV. 240, 241 nn.9-10 and accompanying text. After an examination of cases, the author concludes that "the majority of cases in this country have held that the libelling of large groups can constitute criminal libel whereas only a few cases hold to the contrary." *Id.* at 241 (footnote omitted). *See also supra* text accompanying note 56.

[61]Note, *supra* note 60, at 241 n.8 and accompanying text.

[62]343 U.S. at 302 (Jackson, J., dissenting).

[63]J. NOWAK, R. ROTUNDA & J. YOUNG, CONSTITUTIONAL LAW 944 (2d ed. 1983).

[64]Collin v. Smith, 578 F.2d 1197, 1205 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978); Tollett v. United States, 485 F.2d 1087, 1094 n.14 (8th Cir. 1973); Anti-Defamation League of B'nai B'rith v. F.C.C., 403 F.2d 169, 174 n.5 (D.C. Cir.)(Wright, J., concurring), *cert. denied*, 394 U.S. 930 (1968).

well established.[65] Second, in first amendment cases, the Court has long since abandoned the "rational relationship" test used by Justice Frankfurter to respond to the vagueness issue presented by Beauharnais and to justify the state's restriction of such speech. The standard today is much higher: a law which restricts freedom of speech must be one that is necessary in order to achieve a compelling state interest.[66] Third, the law of libel, from which criminal and group libels law developed, has been modified drastically since *Beauharnais*.

Beginning with *New York Times Co. v. Sullivan*,[67] the Supreme Court has systematically abolished many of the old common law rules of libel law on which the decision in *Beauharnais* was based. For example, the Court has voided the rule that truth is a defense only when the material is published with good motives.[68] Truth is now an absolute defense in a libel suit, even if the purpose of the statement was malicious.[69] Additionally, the Court has abolished the common law rule that if a publication is defamatory *per se*, the plaintiff need not prove actual damages.[70] Today, actual damages must be proven, and punitive damages are not permissible in such civil actions.[71]

Another criticism aimed at the type of criminal group libel statute upheld in *Beauharnais* is exhibited in the more recent libel law decisions.[72] In these cases, there appears to be an overriding concern for "limiting libel laws to cases in which they are *actually necessary* for the protection of reputation."[73] Arguably, the necessity of a group libel statute to protect the reputation of a group, or an individual's interests when the speech is directed at the group, is less than the need for a statute to protect an individual from speech directed specifically at that individual. Furthermore, a *criminal* libel law,[74] designed merely to protect one's reputation, under some circumstances, might be considered "unnecessary and excessively restrictive of speech."[75] Thus, it is easy to understand the criticism

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[65]*See supra* note 54 and accompanying text.

[66]*See, e.g.*, NAACP v. Button, 371 U.S. 415, 438-44 (1963)(because the state failed to "advance any substantial regulatory interest," any broad prohibitions of speech were dissallowed by the first amendment).

[67]376 U.S. 254 (1964).

[68]*See supra* note 43 and accompanying text.

[69]Time, Inc. v. Hill, 385 U.S. 374, 383, 387-91 (1967)(extending the rule to a private plaintiff suing a publication that cast him in a "false light" but did not defame him, when the subject matter was of public interest); Garrison v. Louisiana, 379 U.S. 64, 70-76 (1964). *See also* Gertz v. Robert Welch, Inc., 418 U.S. 323, 348-50 (1974).

[70]*See* Gertz v. Robert Welch, Inc., 418 U.S. at 349.

[71]*Id.* at 348-50.

[72]*See, e.g.*, Collin v. Smith, 447 F. Supp. 676 (N.D. Ill.), *aff'd*, 578 F.2d 1197 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978).

[73]447 F. Supp. at 696 n.15 (emphasis added).

[74]*Beauharnais* involved " 'a form of criminal libel law.' " 343 U.S. at 253 (citation omitted).

[75]447 F. Supp. at 696 n.15. The trial court went on to state that "[s]uch a position would strongly imply that any criminal law designed to punish the infliction of psychological trauma through speech such as racial slurs is unconstitutional, and that the victim should be limited to his tort law remedy." *Id.*

of *Beauharnais*, wherein a criminal group libel law was applied to protect a group from harm.[76]

It is important to note, however, that the majority in *Beauharnais*, and subsequent cases that have referred to *Beauharnais*, correctly characterized the statute involved as one which punished both defamatory speech and speech that was likely to cause violence.[77] Yet, in *Garrison v. Louisiana*,[78] the Court cited *Beauharnais* as an example of a "narrowly drawn [statute] . . . designed to reach speech, such as group vilification, [that is] 'especially likely to lead to public disorders.' "[79] It appears that after *New York Times*[80] and *Garrison*, then, the Supreme Court treats racially defamatory speech as a special category of speech which can be regulated only if it is likely to cause violence or a breach of the peace.

For these reasons, the trial court in *Collin v. Smith*[81] concluded that *Beauharnais* had been overruled, or "at the very least it has been undermined so severely that it should be restricted to its facts."[82] Not everyone, however, is so convinced that *Beauharnais* has been overruled. In the denial of a stay of the court of appeals order in *Smith v. Collin*,[83] Justice Blackmun dissented stating "*Beauharnais* has never been overruled or formally limited in any way."[84] When the writ of certiorari, stemming from the Seventh Circuit decision invalidating the city ordinances was denied, Justice Blackmun again dissented. He urged that certiorari be granted, "in order to resolve any possible conflict that may exist between the ruling of the Seventh Circuit here and *Beauharnais*."[85]

It is fairly clear that *Beauharnais* has been overruled *sub silentio*, Justices Blackmun and Rehnquist (and possibly White) to the contrary notwithstanding. Even if it has not been overturned, the continued linking of group libel laws with the prevention of violence and disorder has surely limited the applicability of the case to a narrow set of facts.

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[76]*See supra* notes 39-64 and accompanying text.

[77]*Beauharnais*, 343 U.S. at 254. In *Beauharnais*, Justice Frankfurter's opinion relied heavily on the history of violence in Illinois as a justification for the passage of such a law. *Id.* at 258-62. *See also supra* note 52 and accompanying text. The Court makes this same point in New York Times Co. v. Sullivan, 376 U.S. 254 (1964), when it refers to its decision in *Beauharnais*. *Id.* at 268-69.

[78]379 U.S. 64 (1964).

[79]*Id.* at 70 (citations omitted).

[80]*See, e.g.*, New York Times V. Sullivan, 376 U.S. 254 (1964).

[81]447 F. Supp. 676 (N.D. Ill.), *aff'd*, 578 F.2d 1197 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978).

[82]447 F. Supp. at 698. The court of appeals in *Collin* also expressed doubts "that *Beauharnais* remains good law at all after the constitutional libel cases." 578 F.2d at 1205.

[83]436 U.S. 953 (1978) (Blackmun, J., dissenting).

[84]*Id.* (Blackmun, J., dissenting). Justice Rehnquist joined in the dissent.

[85]Smith v. Collin, 439 U.S. 916, 919 (1978)(Blackmun, J., dissenting). Justice White joined in the dissent but it is unclear whether he agreed with Justice Blackmun's earlier statement that *Beauharnais* had not been overruled. For a scholarly defense of group defamation laws, see Arkes, *Civility and the Restriction of Speech: Rediscovering the Defamation of Groups*, 1974 SUP. CT. REV. 281.

III. The Indianapolis Ordinance as a Group Libel Law

Assuming *arguendo* that both *Beauharnais* and group libel laws are still constitutionally viable, does the Indianapolis ordinance meet the tests imposed by *Beauharnais*? The answer is dependent upon the ordinance's similarity to the statue approved in *Beauharnais*.

In a clear attempt to meet some of the overt *Beauharnais* conditions, the Indianapolis ordinance[86] appears to contain elements similar to those of the Illinois legislature of which Justice Frankfurter approved in *Beauharnais*.[87] There is, however, one major difference. The Illinois legislature was able to point to a history of racial violence to support its position. The Indianapolis City Council, instead, simply found that "[p]ornography is [both] a discriminatory practice based on sex which denies women equal opportunities in society. . . [and]. . . a systematic practice of exploitation and subordination based on sex which differentially harms women."[88] Such an unsupported statement does not rise to the level of historical evidence upon which the law and opinion in *Beauharnais* were based.[89] The rationale in *Beauharnais* requires a showing that the speech or practice is harmful—it is not enough to show that it is offensive or merely state that it is differentially harmful.[90] Furthermore, to be a valid group libel law, there must be a group against which the speech is directed. That is, it *must* be differentially harmful.

A. The Simple Causal Connection Between Pornography and Harm to Women.

The essence of the feminist argument is that pornography embodies an ideology of "cultural sadism" directed against women.[91] For feminists, pornography is pathognomonic of the "objectification" of females which leads to their treatment in society. Many think the case against pornography is obvious, for they believe a direct causal relationship exists between pornography and violence against women.[92] As one author phrased it, "pornography is the theory, violence is the practice."[93]

Two developments seem to lend support to this argument. First, a series of psychological studies have been conducted which were interpreted

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[86]Indianapolis, Ind., Code of Indianapolis and Marion County, Indiana § 16-1(a)(2) (1984).

[87]343 U.S. at 253-64.

[88]Indianapolis, Ind., Code of Indianapolis and Marion County, Indiana § 16-1(a)(2) (1984).

[89]*See supra* note 52. *See infra* notes 93-98 (data challenging the factual underpinning of the Indianapolis Council's findings and the ordinance itself).

[90]*See supra* notes 9-12 and 18-26 and accompanying text.

[91]The term "cultural sadism" is the author's. However, the concept is very widespread, especially among the more militant feminists. *See, e.g.*, S. Brownmiller, *supra* note 2; K. Millett, Sexual Politics (1970).

[92]*See* R. Morgan, Going Too Far: The Personal Chronicle of a Feminist 165 (1977). *See also infra* notes 107-08 and accompanying text.

[93]Morgan, *supra* note 92, at 165.

as proving that exposure to pornographic movies results in increased hostility and violence against women.[94] Second, there is a perceived increase in violence against women in the media and in pornographic films.[95]

Professor Edward Donnerstein, who was cited at length by the supporters of the Indianapolis ordinance,[96] has conducted a series of laboratory studies on the relationship between erotica, aggressive erotica, and violence toward women. Like earlier researchers, Donnerstein found "no evidence that exposure to nonviolent erotica will increase aggression against women."[97] However, he did find that exposure to violence caused male laboratory subjects to treat females aggressively.[98]

More recently, Donnerstein and his associates have turned to a new technique to assess the relationship between erotica, aggressive erotica, and violence toward women. The new studies attempt to assess the long range effects of exposure to violence and violent erotica, by measuring attitudinal change toward rape victims after exposure to violence. Subjects who had been exposed to violence and violent erotica in films were used as jurors in simulated rape cases. As a result of this exposure, those jurors were less likely to feel sympathy toward the women who claimed they had been raped.

These studies have been used to provide support to the argument that pornography incites violence toward women. In fact, the research was relied upon heavily by the proponents of the Indianapolis ordinance. There are, however, serious methodological problems in attempting to transfer findings regarding laboratory induced anger to the real world.[99] Professor

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[94]Donnerstein, *Pornography and Violence Against Women: Experimental Studies*, 347 ANNALS OF THE NEW YORK ACADEMY OF SCIENCE 277 (1978); Donnerstein, *Facilitating Effects of Erotica on Aggression Against Women*, 36 J. PERS. & SOC. PSYCHOLOGY 1270 (1978); Malamuth, *Testing Hypotheses Regarding Rape: Exposure to Sexual Violence, Sex Differences and Normality of Rapists*, 14 J. RESEARCH IN PERS. 121 (1980).

[95]*See infra* text accompanying notes 102-04.

[96]N.Y. Times, July 3, 1984, § 1, at 8, col. 1.

[97]E. Donnerstein, *Erotica and Human Aggression*, *in* AGGRESSION (R. Geen & E. Donnerstein eds. 1982).

[98]Donnerstein's early research used a research paradigm in which male subjects, angered by a researcher, were shown erotic material and subsequently given an opportunity to give an electrical shock to the original transgressor. The intensity of the shock given by the male subjects to male subjects tended to decline when the erotic film was aggressive or aggressive/erotic but tended to increase when the recipient was female. Although there are alternative explanations for the behavior, for example, male bonding, the findings were hailed by opponents of pornography as proof that pornography led to violence against women.

[99]*See* Gray, *Exposure to Pornography and Aggression Toward Women: the Case of the Angry Male*, 29 SOC. PROB. 347 No. 4 (Apr. 1982) (a review and devastating critique of aggression research). Among other issues, Gray questions whether undergraduate men in a college setting respond to pornography in the same manner as the general male population. Studies of pornography using students usually measure the effect immediately, or ten minutes after exposure. Unless a solid case can be made that short-term experimental results can be transferred directly to the long-term real world, the utility of such studies is limited.

Another problem with most experimental studies, including Donnerstein's, is that the

Donnerstein has even stated that his research has been "misused" by opponents of pornography. "If you take the violent content out of pornographic films and leave only the explicit sex, there is no effect . . . [for] it's the violence, *whether connected with sex or not*, that results in a desensitizing to violence."[100]

Even conservative intellectuals who oppose pornography do not think the theory has been proven that exposure to pornography causes sexual aggression. One of the most conservative scholarly opponents to pornography, Ernest van Den Haag, accepts the feminist argument that pornography is disruptive of the society because it "reduces people simply to bearers of impersonal sensations of pleasure and pain."[101] Yet, he has not been persuaded by any of the tests that pornography causes sexual aggression. "There have been studies on the connection between pornography and sexual aggression, but none serious."[102]

In explaining its harmfulness, feminists maintain that pornography is not merely dehumanizing but that it also objectifies, humiliates, degrades, and physically brutalizes women.[103] However, contrary to this belief, pornographic movies are not about men objectifying women; rather, they exhibit the physical aspects of both genders' sexuality.[104]

Another development buttressing the feminists' argument is a perceived increase in violence against females, both in the mass media and in particular pornographic movies. The cause celebre was the presentation of the pornographic movie *Snuff* just off New York's Time Square, amid

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subject is angered and, subsequently, is required to shock the specific person who angered him. Some shock behavior is required whether the subject desires to administer shock or not. More important is the fact that retaliatory behavior toward a specific person is different from displaced retaliation toward a more general target. Hurting a known or an unknown person after that person has angered or hurt you (with or without seeing a film) cannot be generalized to hurting or desiring to hurt known or unknown persons who have not hurt or angered you.

[100]N.Y. Times, July 3, 1984, § 1, at 8, col. 1 (emphasis added).

[101]*Id.*

[102]*Id.*

[103]S. GRIFFIN, *supra* note 3, at 46. The problem is stated by Griffin:

> If all the literature on pornography were to be represented by one performance, and that performance were to move into its most dramatic moment, the scenes which have been secretly promised by all that has gone before, which will both embody the entire action and meaning of the play and give to its audience the most acute emotional experience, these would have to be the moments (which are inevitable in the pornographic oeuvre) in which most usually a woman, sometimes a man, often a child, is abducted by force, verbally gagged, often tortured, often hung, his or her body suspended, wounded and then murdered.

Id.

[104]*Id. See also* Toolin, *Attitudes about Pornography: What Have the Feminists Missed?*, 17 J. POP. CULTURE 167, 173 (Fall 1983). Toolin states:

> In all cases [of pornography], women and men are shown as weak; neither is in control. Passion is in control; genitals are in control. Women are controlled by their own desires, their insatiable passion, and/or the uncontrollable passions of men. Men are controlled by the desires and passions of women, and by their own insatiable desires and uncontrollable passions.

newspaper stories of an investigating of the widespread private sales of movies in which women were killed. The picketing and publicity which resulted created a perception in many minds that pornography was primarily *about* violence against women.

This perception, however, is largely inaccurate and based on selective perception. Rape scenes and violence against women are relatively rare in mass audience pornographic movies as a matter of definition: pornographic films depict males *and* females overcome by lust, as a result there is almost no resistance to sexual overtures. A recent content analysis of sixty-seven pornographic movies, in both New York City and Houston or Austin, Texas, found very little (less than one percent of the total screen time) sadomasochism or violence. Rather, the study found that men are more likely than females to be the subject of such violence.[105] Based on this data, it arguably appears that the position that women are *routinely* brutalized in pornography is, at the least, biased.[106]

B. Pornography as Per Se Violence Against Women

While some feminists see a simple causal connection between pornography and violence against women, the more sophisticated avoid the evidentiary trap by arguing that pornography is *per se* violence against women. "For whether or not pornography causes sadistic acts to be performed against women, above all pornography is in itself a sadistic act."[107] This is

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[105]There were only 3 rape scenes in the 67 movies analyzed. The sample also included 3 females who were killed. However, in all 3 cases, there was no sexual context: one was accidental; one was the killing of a female witness to a crime; and one duelist, not known to be female until later killed. By contrast, seven men were killed, another was assaulted with a blowtorch, and another by a knife-wielding woman.

[106]*Pornotopia in the 1980s: A Content Analysis of Contemporary American Pornographic Films* (presented by W. Brigman at the American Popular Culture Association Annual Meeting, Wichita, Kansas on April 22, 1983). The following is a complete listing of acts of violence against women in the 67 films:

> woman chained, still photo of whip (no on-screen violence); women tied up after announcing such a desire; physician rapes patient, asks for forgiveness; sex-initiation scene, girl cries afterwards; Indian woman raped, fights to end; woman assaulted by Indian woman's relatives, enjoys it, marries the Indian; woman tied to tree to observe husband (no other violence); man stalks woman with knife (not real); shooting; movie man ties up his wife to prevent her disclosing his plans; bondage scene; one stroke spank; "pretend I'm beating you"; three real strokes; female-female punishment by spanking (heard, not seen); two female spanking scene, bondage only; accidental (?) killing; killing of female witness (no sexual context); one slap during photo session for realism; two girls kidnapped; they make sexual overtures; two slaps on woman's hips during intercourse at her request; woman kidnapped and tied up, berates kidnappers as impotent; female duelist killed, not known she is female; attempted rape by mental defective aborted by his sister.

[107]S. GRIFFIN, *supra* note 3, at 111. Griffin goes on to note:

> Let us remember that the central experience of sadomachism is humiliation. The actual images of pornography degrade women. This degradation is the essential experience of pornography. It can be argued that for a woman to be

the philosophy underlying the feminist argument and the Indianapolis ordinance against pornography. It matters not that there is no evidence that pornography causes violence against women because pornography *per se* is violence against women—it "*is in itself a sadistic act.*"[108]

The argument is fatally flawed, both logically and constitutionally. First, it avoids having to demonstrate clearly that the speech or practice is harmful. Second, it assumes that pornography *uniquely* objectifies women and, as such, "differentially harms women."[109] Yet, unless it can be proven that pornography *differentially* harms women, there can be neither a group libel nor a civil rights violation.[110] Women alone, however, are not objectified in pornography; people are objectified. The differential treatment which is assumed, in reality, does not exist.

The ordinance itself is logically inconsistent on this point. Although "pornography" is uniquely defined in section 16-3 as both written and pictorial works where *women* are "presented as sexual objects who enjoy pain . . . [or] as sexual objects for domination, conquest, violation, exploitation, possession, or use, or through postures or positions of servility or submission or display,"[111] the word "women" is specifically said to also apply to "men, children, or transsexuals."[112]

Not only does this destroy the group libel and civil rights logic underlying the law, and its very reason for being, it also makes the definition incomprehensible and unconstitutionally vague. By definition, a group libel law must protect something less than the entire population. Without an element of exclusivity or inclusivity, the act ceases to be either a group libel law or a civil rights law. It becomes, instead, a calculated attempt to

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> disrobed in public at all, given the values of this culture, is a degradation . . . . She has been paid to take off her clothing. And she has about her posture the attitude of a whore who has been paid to move in a certain way. She is chattel. When she is chained, her chains are redundant, for we know that she is not a free being. The whole value, the thrill of the "peep show" or a centerfold depends on a woman's degradation. In this way she plays the whore. For she is *literally* for sale. Her image, printed on a newspaper, is reproduced countless times, and lies flat under a plastic screen, to be had for twenty-five or fifty cents by a passing man.

Id.

[108] *Id.*

[109] INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-1(a)(2) (1984).

[110] A practice which treats all individuals alike, even negatively, is not discrimination nor is it "group" libel. While it may be possible that the entirety of the American population constitutes a "group" in the nonlegal use of the term, the concept of "group discrimination" or "sex discrimination" logically requires that the "group" be a subset of the population. The key element in the concept of discrimination is the arbitrary selection from a number of persons "all of whom stand in the same relation to the privileges granted, and between whom and [those] not so favored no reasonable distinction . . . can be found." Franchise Motor Freight Assoc. v. Seavy, 196 Cal. 177, 180, 235 P. 1000, 1002 (1925).

[111] INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(q)(1), (6) (1984).

[112] *Id.* § 16-3(q).

suppress literature, art, and speech merely because it offends. This is not constitutionally permissible.

IV. The Indianapolis Ordinance and the First Amendment

Among other factors, the ordinance is fatally flawed as either a group libel law or civil rights law by its inclusion of the entire human race. Therefore, the only question that remains is whether or not it can survive standard first amendment scrutiny.[113] In *American Booksellers Association, Inc. v. Hudnut*,[114] United States District Court Judge Sarah Evans Barker found the answer was no.

Viewed from the perspective of first amendment jurisprudence, the ordinance suffers from a variety of major constitutional defects. Chief among these are excessive vagueness, failure to comply with the established definition of obscenity, irreconcilable conflict with the concept of the avertable eye, the attempt to create third party tort liability for injuries "caused" by "pornography," and an administrative system of prior censorship which is inconsistent with the requirements established by the United States Supreme Court.[115]

A. Excessive Vagueness

The ordinance's language is rooted in feminist philosophy.[116] As a result, the statute contains words and phrases left undefined outside of feminist rhetoric and employs them in a manner inconsistent with standard usage. The term "pornography" is the most obvious of these for reasons stated above, but the law is replete with others.[117] For example, one key word, "subordination," is never defined in the ordinance, nor is its meaning made clear from the context in which it is used.[118] The standard definition of "subordination" is "placed in a lower order, class, or rank . . . inferior in . . . dignity, power, importance, or the like . . . secondary,

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[113]In order to be constitutionally valid, a law restricting freedom of speech must meet one of the exceptions specifically enumerated by the United States Supreme Court: 1) libel and slander (group libel laws, if they are still constitutionally valid, are a variant of this category); 2) "fighting words"; or 3) obscenity. Chaplinsky v. New Hampshire, 315 U.S. 568, 572 (1942). Although cast as a civil rights law, the Indianapolis ordinance must fit within one of these special categories, or be subjected to the normal rules which govern limitations on freedom of speech.

[114]598 F. Supp. 1316 (S.D. Ind. 1984). *See supra* note 5.

[115]*See supra* notes 18-26 and accompanying text.

[116]*See, e.g.*, Elshtain, *The New Porn Wars*, The New Republic, June 25, 1984; N.Y. Times, June 10, 1984, § 4, at 2, col. 3.

[117]The plaintiffs in *American Booksellers* challenged the word "pornography" along with several others as being unconstitutionally vague. 598 F. Supp. at 1337-38.

[118]"Pornography shall mean the graphic sexually explicit subordination of women . . . ." Indianapolis, Ind., Code of Indianapolis and Marion County, Indiana § 16-3(q). The *American Booksellers* court concentrated its vagueness discussion on the phrase "subordination of women." 598 F. Supp. at 1337-39.

minor."[119] Presumably, the ordinance uses the word differently. Otherwise, any presentation of a female in a role other than the highest status role possible in an artistic presentation would be impermissible.

The attempt to create a new definition of pornography only compounds the problem of clarity. For example, the essence of the definition is the term "presented as sexual objects." While that term may be clear to a radical feminist, it is essentially meaningless to one not versed in the peculiar language of feminism. Other terms used in the definition share the same flaw, such as "who enjoy . . . humiliation; . . . presented in scenarios of degradation . . . shown as . . . inferior; . . . presented . . . for . . . conquest . . . through postures or positions of servility or submission or display."[120] Not only does the ordinance attempt to prevent a presentation of bondage, which some do not consider improper, or immoral, or degrading, but if interpreted literally the "posture . . . of submission" prohibition would outlaw any art work involving nudity where the female is not superior.

Equally ambiguous is section 16-3(g)(6), which makes the "forcing of pornography on a person" a discriminatory practice. What constitutes "forcing?" If a host suggests to a guest that a recent issue of a magazine has an excellent article on a black political leader and gets a copy of the magazine for the guest to read and the magazine meets the statutory definition of "pornography," is that forcing?

To one versed in antipornography linguistics, the apparent ambiguities are not ambiguous at all.[121] However, merely because one group in a society understands its idiosyncratic use of the English language does not protect that language from the charge of being unconstitutionally vague. Quite the contrary: it enhances the charge. Adequate notice of violation of law requires that the law use language within the usual framework of meaning. As noted by the district court, "Persons subjected to this Ordinance cannot reasonably steer between lawful and unlawful conduct, with confidence that they know what its terms prohibit."[122] This places a special burden upon those who create new concepts, a burden to use language to make those concepts clear. The Indianapolis ordinance is couched in propagandistic rather than legal terms, and is therefore unconstitutionally vague.

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[119]BLACK'S LAW DICTIONARY 1278 (rev. 5th ed. 1979).

[120]INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(q) (1984). The *American Booksellers* court also pointed to the vagueness of these terms. 598 F. Supp. at 1338-39.

[121]For example, to one not familiar with the logic or language of feminists, the statement regarding women and penetration by objects is unconstitutionally vague because it could include a woman who was shot or stabbed. *See* INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(q)(4)(1984). However, one familiar with the vocal objection of feminists to presentations of scenes in which women are shot or stabbed will realize that the language is intentionally broad in order to outlaw violent movies.

[122]*American Booksellers*, 598 F. Supp. at 1339.

B. Is It Constitutionally Possible to Proscribe Nonobscene Material?

Leaving aside the specific linguistic deficiencies of the ordinance, an important question posed by the Indianapolis ordinance is the extent to which nonobscene material can be proscribed without violating the free speech and press guarantees of the first amendment. Under the first amendment, "speech may not be punished merely because it offends."[123] Only speech which constitutes "the lewd and obscene, the profane, the libelous, and the insulting or 'fighting' words"[124] and "child pornography"[125] may be proscribed. The exception for "libelous" material is inapplicable in this case because the Indianapolis ordinance is much broader. Therefore, the only reasonable category upon which the law can be based is "obscenity." This too is inapplicable.

In *Miller v. California*,[126] the United States Supreme Court created a three-prong test which must be met before sexually related material may be restricted as obscene and therefore devoid of first amendment protection:

> (a) whether "the average person, applying contemporary community standards" would find that the work, taken as a whole, appeals to the prurient interest . . . ; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value.[127]

The *Miller* Court made it clear that material which did not meet this test for obscenity could not be proscribed, and further required that the controlling ordinance specifically detail the type of material outlawed.[128]

The Indianapolis ordinance makes virtually no attempt to meet any of the tests established by the United States Supreme Court in *Miller*. It does not refer to a "community standard" test, nor does it require that the material be "patently offensive."[129] Furthermore, the closest that the ordinance comes to an exemption for works that have serious "literary, artistic, political or scientific value" is a limited exemption for "[c]ity, state,

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[123]Collin v. Smith, 447 F. Supp. 676, 697 (N.D. Ill.), *aff'd*, 578 F.2d 1197 (7th Cir.), *cert. denied*, 439 U.S. 916 (1978).

[124]Chaplinsky v. New Hampshire, 315 U.S. 568, 572 (1942); *see* Miller v. California, 413 U.S. 15 (1973). *See also American Booksellers*, 598 F. Supp. at 1331 (quoting *Chaplinsky* for the same proposition).

[125]New York v. Ferber, 458 U.S. 747 (1982). *See also American Booksellers*, 598 F. Supp. at 1331 (citing *Ferber*).

[126]413 U.S. 15 (1973).

[127]*Id.* at 24 (citations omitted). Judge Barker, in *American Booksellers*, noted that the *Miller* obscenity test was not directly applicable to the Indianapolis ordinance because the ordinance, as acknowledged by the defendants, sought to proscribe speech that was not obscene. 598 F. Supp. at 1331-32.

[128]This position was reaffirmed the following year in Jenkins v. Georgia, 418 U.S. 153 (1974).

[129]*See American Booksellers*, 598 F. Supp. at 1332.

and federally funded public libraries or private and public university and college libraries in which pornography is available for study."[130] However, even that exemption does not cover "special display presentations" (which are not defined in the ordinance), also leaving other institutions or individuals not named. Thus, the private or public art museum which displays erotic etchings from Picasso, and the bookstore which sells such collections, would be subject to a discrimination order.[131]

The major flaw in the legislative scheme, however, is its attempt to restrict nonobscene materials. The intent is evident from the provision in the original ordinance,[132] subsequently deleted by amendment,[133] which defined "sexually explicit" material to include "[u]ncovered exhibition of the genitals, pubic region, buttocks or anus of any person."[134] Such material obviously is not within the "hardcore pornography" that Chief Justice Burger stated in *Miller* was the only type that could be proscribed.[135]

The deletion of the inappropriate definition by amendment does not remedy this defect, for under *Miller*, the legislative body must explicitly state the types of activity which are proscribed.[136] It could be argued that Indianapolis is a creature of the State of Indiana and, therefore, the state's definition of "sexually explicit" is controlling. Such an argument is, however, both illogical and self-defeating. The state obscenity law[137] is a criminal statute which defines obscenity in accordance with *Miller*. As such, the state statute is not broad enough to reach the type of material which the city attempts to regulate. Imputing the state statute to the Indianapolis ordinance would render the ordinance no more effective than the current Indiana law, thereby defeating the purpose of the ordinance.

C. The Concept of the Avertable Eye

An irreconcilable conflict exists between the feminist proposals[138] to control pornography and the United States Supreme Court's concept of

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[130]The ordinance reads: "City, state, and federally funded public libraries or private and public university and college libraries in which pornography is available for study, including on open shelves, shall not be construed to be trafficking in pornography, but special display presentations of pornography in said places is sex discrimination." INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(g)(4)(A)(1984).

[131]Section 16-3(g)(4)(C) provides that the paragraph regarding trafficking in pornography "shall not be construed [as making] isolated passages or isolated parts actionable." *Id.* Presumably, this phrase is an attempt to incorporate the *Miller* requirement that a work be considered as a whole. 413 U.S. 15, 24 (1973). But since it is in a section which deals with trafficking in pornography rather than in the definition of pornography, its meaning and intent are unclear.

[132]Section 16-3(bb) of the original amendment was signed into law on May 1, 1984.

[133]The definition was deleted in the subsequent amendment, signed into law on June 15, 1984.

[134]INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(bb), *repealed by*, General Ordinance No. 35 (June 1, 1984).

[135]413 U.S. 15 (1973).

[136]*Id.* at 24.

[137]IND. CODE §§ 35-49-1-1 to -3-4 (Supp. 1984).

[138]*See supra* notes 1-3.

the avertable eye. The first amendment strictly limits the government's power to act as a censor.[139] As such, "the burden normally falls upon the viewer to 'avoid further bombardment of [his] sensibilities . . . by averting [his] eyes.' "[140] However, the feminist position is that pornography is so pervasive in the society and so harmful in its impact that it is impossible to avoid it, or its impact, by averting the eyes.

One interpretation of this position, adopted by the Indianapolis ordinance, is that pornography is sexual harassment and could be outlawed if it were explicitly forced upon a female in the workplace.[141] The Equal Employment Opportunity Commission (EEOC) and the courts have recognized that sexual harassment is gender based discrimination and, that as such, it violates section 703 of the Civil Rights Act of 1964.[142] The EEOC and the courts agree that employers have an affirmative duty under Title VII of the Act to maintain a working environment free of discriminatory insult, intimidation, and other forms of harassment on the basis of race, religion, national origin, or sex.[143] It is fairly clear that under this section, the posting or open circulation of pornography in a workplace would constitute sexual harassment in the same sense that an employer's tolerance of ethnic jokes directed at an employee is prohibited national origin harassment.[144] In connection with the avertable eye concept, while in a work environment, one cannot, and should not, be forced to quit work or be fired from her employment in order to avoid being sexually harassed.

The attempt, however, to expand this sexual harassment concept from the workplace to society at large cannot stand constitutional or logical scrutiny. "Forcing" pornography on a female employee as a condition for

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[139]Erznoznik v. Jacksonville, 422 U.S. 205, 209-10 (1975).

[140]*Id.* at 210-11 (quoting Cohen v. California, 403 U.S. 15, 21 (1971)). Justice Powell spoke for the majority in *Erznoznik*:

> [W]hen the government, acting as censor, undertakes selectively to shield the public from some kinds of speech on the ground that they are more offensive than others, the First Amendment strictly limits its power. . . . Such selective restrictions have been upheld only when the speaker intrudes on the privacy of the home . . . or the degree of captivity makes it impractical for the unwilling viewer or auditor to avoid exposure. . . .
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> . . . .
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> [T]he Constitution does not permit government to decide which types of otherwise protected speech are sufficiently offensive to require protection for the unwilling listener or viewer. Rather, absent the narrow circumstances described above, the burden normally falls upon the viewer to "avoid further bombardment of [his] sensibilites simply by averting [his] eyes."

422 U.S. at 209-11 (footnotes and citations omitted).

[141]*See supra* note 9.

[142]42 U.S.C. § 2000e-2(a) (1984). The EEOC's *Guidelines on Discrimination Because of Sex* states that "Unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature constitutes sexual harassment when . . . such conduct has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile or offensive working environment." 29 C.F.R. 1604.11(a) (1984).

[143]EEOC Dec. (CCH) ¶ 6757 (Feb. 6, 1981).

[144]*See* EEOC Dec. (CCH) ¶ 6085 (Dec. 16, 1969).

continued employment is not analogous to allowing other individuals to purchase or view the same material in an art gallery, a movie theatre, or their own homes. This, however, is precisely the flawed analogy on which the Indianapolis ordinance is based.

D. The Constitutionality of Third Party Tort Actions for Injuries "Caused" by Pornography

Consistent with the belief that pornography breeds violence against females, the Indianapolis ordinance creates a tort action authorizing a claim against anyone in the chain of publication and distribution, when a person is attacked by another acting under the influence of the outlawed materials.[145] Leaving aside the difficulty of proving causation, this provision is directly contrary to a significant number of cases which have rejected the attempt to create third party liability based on exposure to communicative materials of the type contemplated in the ordinance.[146] For example, the Rhode Island Supreme Court dismissed the claim of parents who contended that a television network was liable for the death of their son who had attempted to copy a stunt seen on *The Tonight Show*. The court determined that to allow recovery "on the basis of one minor's actions would invariably lead to self-censorship by broadcasters in order to remove any matter that may be emulated and lead to a law suit."[147]

In a more analogous case to the issue at hand, the Federal District Court for the Southern District of Texas dismissed a suit involving liability for publishing a sex-related article which allegedly caused the death of two people. The court found that "[c]ourts have found that First Amendment considerations . . . argue against the liability of a publisher for a reader's reactions to a publication, absent incitement."[148]

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[145]"The assault, physical attack, or injury of any woman, man, child, or transsexual [is accomplished] in a way that is directly caused by specific pornography." INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(b)(7)(1984). *See also id.* §§ 16-17. *See American Booksellers*, 598 F. Supp. at 1341.

[146]See Herceg v. Hustler Magazine, Inc., 565 F. Supp. 802 (S.D. Tex. 1983); Zamora v. Columbia Broadcasting System, 480 F. Supp. 199 (S.D. Fla. 1979); Olivia N. v. National Broadcasting Co., 126 Cal. App. 3d 488, 178 Cal. Rptr. 888 (1981), *cert. denied.*, 458 U.S. 1108 (1982); DeFilippo v. National Broadcasting Co., 446 A.2d 1036 (R.I. 1982).

[147]DeFilippo v. National Broadcasting Co., Inc., 446 A.2d 1036, 1041 (R.I. 1982)(footnote omitted).

[148]Herceg v. Hustler Magazine, Inc., 565 F. Supp. 802, 804 (S.D. Tex. 1983)(footnote omitted). In the well-publicized "Born Innocent" case, the California Court of Appeals specifically discussed the analogy between prior restraint on speech and civil liability premised on traditional negligence concepts. It concluded that "the chilling effect of permitting negligence actions for a television broadcast is obvious. 'The fear of damage awards . . . may be markedly more inhibiting than the fear of prosecution under a criminal statute.' " Olivia N. v. National Broadcasting Co., 126 Cal. App. 3d 488, 495, 178 Cal. Rptr. 888, 892 (1981), *cert. denied.*, 458 U.S. 1108 (1982) (quoting New York Times Co. v. Sullivan, 376 U.S. 254, 277 (1964)).

In addition to the chilling effect these potential civil damages have on "the exercise of first amendment freedoms,"[149] the provision which makes those "trafficking in pornography"[150] responsibile for third party acts of violence or discrimination is defective because it does not postulate a reasonable person test. Under the Indianapolis ordinance, if the most susceptible person in the society were exposed to pornographic material and injured another, all persons in the chain of production and distribution would be liable. This resulting liability would have the unconstitutional effect of reducing what normal adults could view to that which would not adversely motivate the most impressionable and/or morally bent person in the society. Surely this concept, quite similar to strict liability, does not comport with the constitutional protections enunciated by the United States Supreme Court.[151]

E. Constitutional Limitations on the Powers of Censorship Boards

Under the Indianapolis ordinance, the city's Office of Equal Opportunity (OEO) becomes in essence a censorship board with broad discretion and powers, including the power to issue cease and desist orders and impose sanctions.[152] Although the decisions of the OEO are subject to judicial review in contested cases, the procedures established in the ordinance do not meet the constitutional tests developed by the courts.[153] As the United States Supreme Court has noted, a system of prior restraint "comes to [the] Court bearing a heavy presumption against its constitutional validity."[154]

Even in those cases where the material involved was obscene and unprotected under the Constitution, a censorship body has been upheld "only

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[149]Washington Post Co. v. Keogh, 365 F.2d 965, 968 (D.C. Cir. 1966), *cert. denied*, 385 U.S. 1011 (1967).

> The threat of being put to the defense of a lawsuit brought by a popular public official may be as chilling to the exercise of First Amendment freedoms as fear of the outcome of the lawsuit itself . . . . Unless persons . . . desiring to exercise their First Amendment rights are assured freedom from the harassment of lawsuits, they will tend to become self-censors.

Id. See also New York Times Co. v. Sullivan, 376 U.S. 254 (1964).

[150]INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA § 16-3(b)(7) (1984).

[151]Erznoznik v. Jacksonville, 422 U.S. 205 (1975).

[152]*See* INDIANAPOLIS, IND., CODE OF INDIANAPOLIS AND MARION COUNTY, INDIANA §§ 16-26(d), (e)(1984). These sections empower the committee and subsequently the board, prior to a judicial determination of the controversy, to issue cease and desist orders, to restore the complainant's losses, and take other steps they "deem necessary to assure justice," and to initiate license revocation procedures against individuals found in violation of the ordinance. The power is denied in cases where actual direct physical harm is alleged. *Id.* §§ 16-27(e). *See also American Booksellers*, 598 F. Supp. at 1340-41.

[153]*See* Freedman v. Maryland, 380 U.S. 51 (1965); Bantam Books, Inc. v. Sullivan, 372 U.S. 58 (1963). *See also American Booksellers*, 598 F. Supp. at 1340-41 (citing the *Freedman* decision at length).

[154]Bantam Books, Inc. v. Sullivan, 372 U.S. 58, 70 (1963)(citations omitted). *See also American Booksellers*, 598 F. Supp. at 1340 (quoting *Bantam Books* for the same proposition).

where it operated under judicial superintendence and assured an almost immediate judicial determination of the validity of the restraint."[155] In a somewhat analogous instance, a federal district court voided a city ordinance which allowed the city manager to impose fines for the commercial exploitation of obscenity because it was an "informal system of prior restraint operated entirely by a political official."[156] The trial court found that the ordinance placed pressure on bookstores to pay the fine "and forego the expense and risk of a court test of the City Manager's personal judgment of what is obscene."[157] The Indianapolis ordinance operates in essentially the same way, with the Office of Equal Employment directing the system of restraint.

Moreover, the United States Supreme Court has set forth specific procedural safeguards which must be incorporated into any scheme of prior administrative censorship.

> *First*, the burden of instituting judicial proceedings, and of proving that the material is unprotected, must rest on the censor. *Second*, any restraint prior to judicial review can be imposed only for a specified brief period and only for the purpose of preserving the status quo. *Third*, a prompt final judicial determination must be assured.[158]

None of these protections is found in the Indianapolis ordinance. The first action under the Indianapolis procedures is an informal attempt by a committee of the OEO to resolve the issue, followed by a public hearing, a committee decision, an appeal within thirty days to the entire OEO, a decision by the OEO within thirty days of the filing, and a recourse to the courts within ten days after the application of OEO sanctions. When coupled with the time involved for judicial review, the process may take months or even a year, during which time the OEO's cease and desist order and/or fine remains in effect. Such a procedure does not meet the constitutional requirement of a "prompt final judicial determination."[159] Nor does the procedure meet the requirement that the cease and desist order run "only for a specified brief period and for the purpose of preserving the status quo."[160]

The net effect of the administrative procedures required by the Indianapolis ordinance is to delay the consideration of challenged material

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[155]Bantam Books, Inc. v. Sullivan, 372 U.S. 58, 70 (1963) (citations & footnote omitted).

[156]U.T., Inc. v. Brown, 457 F. Supp. 163, 168 (W.D.N.C. 1978). The ordinance conformed to the *Miller* obscenity standards but its enforcement, nevertheless, presented an unconstitutional prior restraint.

[157]*Id.* at 169.

[158]Southeastern Promotions, Ltd. v. Conrad, 420 U.S. 546, 560 (1975). *See also* Blount v. Rizzi, 400 U.S. 410, 417 (1971); Freedman v. Maryland, 380 U.S. 51, 58-59 (1965). The *American Booksellers* court also relied on this analysis. 598 F. Supp. at 1340.

[159]Southeastern Promotions, Ltd. v. Conrad, 420 U.S. 546, 560 (1975). Nor does such a procedure provide an "almost immediate judicial determination of the validity of the restraint." Bantam Books, Inc. v. Sullivan, 372 U.S. 58, 70 (1963)(footnote omitted).

[160]Southeastern Promotions, Ltd. v. Conrad, 420 U.S. 546, 560 (1975).

until it is no longer current or salable. This is especially true in the case of dated material such as magazines which depend on timeliness to generate interest and sales, but it is also true of popular books which must normally sell during the relatively short period when they are new or popular if they are to be commercially successful. Such an effect is clearly unconstitutional.

V. Conclusion

Unless the concept of group libel is to be resurrected with a greatly expanded scope, the Indianapolis attempt to outlaw pornography as a form of sexual discrimination and harassment against women cannot survive the basic constitutional tests normally applied to governmental attempts to limit expression. The law is not analogous to the group libel law that was upheld in *Beauharnais v. Illinois*,[161] then subsequently undermined in later decisions. The racial epithets in that case were explicitly directed at blacks and there was a record of violence against blacks in the state. Relying on unproven (and arguably false) assumptions about the nature and effects of pornography, the Indianapolis ordinance attempts to regulate images, not explicit verbal expression. There is a vast difference between Joseph Beauharnais' explicit attacks on blacks in his leaflets and the indirect commentary on women found in pornographic materials. Moreover, the "fighting words" rationale which supported the Illinois statute is missing in the Indianapolis ordinance. Instead, the ordinance relies on another unsupported argument, that pornography leads to violence against women.

While the concept of "forcing" pornography has some validity in the limited environs of the workplace, that concept poses grave dangers to freedom of communication when transferred to the society as a whole. One of the most troublesome aspects of the Indianapolis censorship procedure is that it allows a politically sensitive body, acting on the basis of a philosophical statement cast in the form of a very vague, confusing, and logically inconsistent law, to determine what is the proper image of a group to be portrayed in all forms of communication in all locations. It is precisely this type of censorship activity that the United States Supreme Court has tried to prevent by a series of decisions which have established specific limitations on censorship boards, and have narrowed the concepts of libel and group libel.

The long and bitter controversy over pornography and obscenity attests to the fact that it offends many in the society, both men and women. Nevertheless, attempting to limit speech by using a law that does not meet the constitutional safeguards or standards established by our highest Court, no matter how noble the goals, is offensive and restrictive of one of our most basic freedoms—that of free speech.

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[161] 343 U.S. 250 (1952).

Solving Statute of Limitations Problems Under the Fair Credit Reporting Act

MARTHA F. DAVIS*

In 1981, Mr. Smith decided to buy a house and proceeded to seek a loan for the purchase. Upon submitting a loan application to the home loan division of his bank, Mr. Smith's credit was investigated by a bank loan officer—a routine procedure in such transactions. However, Mr. Smith's application was rejected. When Mr. Smith obtained a copy of his credit report, he discovered an error that had affected his credit rating and had caused the bank to reject his loan application. He informed the credit agency of the problem and was told that the error would be erased from the agency's computer record. In 1982, Mr. Smith decided to buy a car. Again, his application for a loan was refused on the basis of the same erroneous credit report. Smith contacted the agency again and was assured that the error would be erased. More than two years later, in 1985, Mr. Smith applied for a credit card. When his application was refused because of the same uncorrected error, Mr. Smith filed for relief in federal court, claiming that the credit reporting agency had violated the provisions of the Fair Credit Reporting Act (FCRA).[1]

The FCRA requires that credit reporting agencies adopt "reasonable procedures"[2] to ensure the "confidentiality, accuracy, relevancy, and proper utilization"[3] of the information which they gather and provide to

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[1]Fair Credit Reporting Act § 601, 15 U.S.C. § 1681 (1982) [hereinafter cited as FCRA]. This Act is an amendment to the Consumer Credit Protection Act, 15 U.S.C. § 1601 (1982). For a general review of the FCRA see Annot., 17 A.L.R. FED. 675 (1973). *See also* Kaswell & Sullivan, *Credit Reporting and Collection Practices*, 38 BUS. LAW. 1371 (1983).

[2]15 U.S.C. §1681b. Section 1681e explains that a credit bureau discharges its obligation to maintain reasonable procedures by making certain that reports are accurate and by divulging the contents of a subject's file only upon a proper request. 15 U.S.C. § 1681e. *See* Note, *Protecting the Subjects of Credit Reports*, 80 YALE L.J. 1035, 1066-67 (1971). Judicial definitions of "reasonable procedures" are discussed *infra* at notes 26-30.

According to one commentator, "[This] agreement stands for the proposition that whenever credit bureaus reasonably should know of systematic errors in their reporting systems, then they must evaluate and implement system adjustments that could reduce the inaccuracies in a cost-effective manner." Fortney, *Consumer Credit Compliance and the Federal Trade Commission: Sketching the New Directions*, 39 BUS. LAW. 1305, 1313 (1984) (footnote omitted). "[This calling] for incremental increases in the accuracy of the credit information system" takes account of the fact that one hundred percent accuracy is probably unattainable at any cost. *Id.*

[3]15 U.S.C. §1681b. *See, e.g.*, Heath v. Credit Bureau of Sheridan, Inc., 618 F. 2d 693 (10th Cir. 1980) (plaintiff properly stated a claim against the credit agency for transmitting a credit report for an impermissible purpose).

potential lenders.[4] The FCRA also provides for a two-year statute of limitations for suits arising from negligent error in credit reports.[5] Unfortunately, however, the section outlining the time limitations is poorly drafted. As a result, the statute of limitations found in the FCRA creates a problem for those attempting to interpret it.[6] For example, in Smith's case, the inaccurate report raises a question regarding the agency's procedures,[7] and Mr. Smith's claim for the 1985 incident appears to be well-founded. But whether Mr. Smith can sue the agency for losses he previously incurred as a result of the identical error appearing in the 1981 and 1982 reports is a question of first impression the courts have yet to answer.

This Article addresses two related questions posed by Mr. Smith's FCRA claim: (1) when does the two-year statute of limitations for negligent error begin to run;[8] and, (2) can consumers recover for a "continuing error,"[9] one which began outside the two-year period, but persisted within two years of the suit?[10] The statute is ambiguous.

Recent cases illuminate the first question, but do not set out a formula that can be used by trial courts confronted with the issue. The second question of "continuing error" has been raised by parties to FCRA suits,[11] but never directly addressed by the courts. This Article argues that both questions can be answered with reference to the law

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[4]The FCRA governs two types of consumer reports: investigative consumer reports and economic consumer reports. An investigative report, which might be requested by a potential employer or insurance company, includes personal or subjective information on a person's character and general reputation. Such information is often gathered through personal interviews with friends or associates of the consumer. 15 U.S.C. § 1681a(e). An economic report contains information bearing more directly on an individual's credit worthiness, i.e., a credit history. 15 U.S.C. § 1681a(d). For a general discussion of both types of reports, see Note, *Credit Investigations and the Right to Privacy: Quest for a Remedy*, 57 GEO. L.J. 509 (1969); Note, *Consumer Protection: Regulation and Liability of the Credit Reporting Industry*, 47 NOTRE DAME LAW. 1291, 1292-95 (1972).

[5]15 U.S.C. § 1681p. *See infra* text accompanying note 20. For analysis and discussion of FCRA provisions, see generally Note, *Judicial Construction of the Fair Credit Reporting Act: Scope and Civil Liability*, 76 COLUM. L. REV. 458 (1976) [hereinafter cited as *Judicial Construction*]; Note, *The Fair Credit Reporting Act*, 56 MINN. L. REV. 819 (1972); Comment, *The Impact of the Fair Credit Reporting Act*, 50 N.C.L. REV. 852 (1972).

[6]*See* 15 U.S.C. § 1681p.

[7]*See* Bryant v. TRW, Inc., 487 F. Supp. 1234, 1240, 1242 (E.D. Mich. 1980), *aff'd*, 689 F.2d 72 (6th Cir. 1982) (once report is found to be inaccurate in fact, jury must determine whether consumer reporting agency followed reasonable procedures to ensure reasonable accuracy). *See also* Hauser v. Equifax, Inc., 602 F.2d 811, 814-15 (8th Cir. 1979) (the inaccuracy itself is not a touchstone).

[8]*See infra* notes 24-59 and accompanying text.

[9]A "continuing error," like a continuing violation, is an error which gives present effect to a past negligent act—the unreasonable credit agency procedure. *See, e.g.*, United Air Lines, Inc. v. Evans, 431 U.S. 553 (1977).

[10]*See infra* notes 59-82 and accompanying text.

[11]Lawhorn v. Trans Union Credit Information Corp., 515 F. Supp. 19 (E.D. Mo. 1981).

of defamation, which underlies the FCRA legislation, tempered by recognition of the FCRA's consumer-oriented purpose.

I. The Statute

In 1970, Congress attempted to curb the growing power of credit reporting agencies with passage of the FCRA. The stated purpose of the FCRA is to "require that consumer reporting agencies adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner which is fair and equitable to the consumer, with regard to the confidentiality, accuracy, relevancy, and proper utilization of such information . . . ."[12]

The statute imposes significant responsibilities on credit reporting agencies. Among other things, the FCRA limits the uses for which a consumer credit report can be released,[13] and provides a flow chart for challenging a report's accuracy.[14] If a consumer challenges any information contained in his file, the agency must reinvestigate.[15] If the information is confirmed upon reinvestigation, the consumer may file a statement of the dispute, and any disputed information will be noted as such in forthcoming reports.[16] Furthermore, the agency is to inform the consumer of any information deleted from his report.[17] As a general matter, the FCRA requires that a credit reporting agency maintain "reasonable procedures," and exert a "reasonable effort" in reporting and verifying consumer information.[18] An agency which fails to conform to these standards is exposed to civil liability.

Federal jurisdiction is granted in section 1681p of the FCRA.[19] That section also sets out the applicable statute of limitations for actions brought in federal court. Suits may be brought:

> . . . within two years from the date on which the liability arises, except that where a defendant has materially and willfully misrepresented any information required under this subchapter to be disclosed to an individual and the information so misrepresented is material to the establishment of the defendant's liability to that individual under this subchapter, the action may be brought at any time within two years after discovery by the individual of the misrepresentation.[20]

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[12]15 U.S.C. §1681b (1982).

[13]*Id.* at § 1681b.

[14]*Id.* at § 1681i. *See* Stewart v. Credit Bureau Inc., 734 F.2d 47, 49 n.2 (D.C. Cir. 1984).

[15]15 U.S.C. § 1681i(a) (1982).

[16]*Id.* at § 1681i(b)-(c).

[17]*Id.* at § 1681i(d).

[18]*Id.* at §1681b & § 1681e.

[19]*Id.* at § 1681p. Civil liability for willful and negligent noncompliance with the FCRA arises under sections 1681n and 1681o, respectively.

[20]*Id.* at § 1681n, § 1681o, § 1681p.

The FCRA explicitly states that this grant of federal jurisdiction does not preclude the effect of state law.[21] To date, fourteen states have enacted laws which regulate consumer reporting agencies.[22] Under certain circumstances, an FCRA claim may also be joined with the common law claims of negligence, invasion of privacy, and commercial defamation, which are somewhat limited by the FCRA.[23]

II. When Does the Two-Year Statute of Limitations Begin to Run?

The FCRA's limitations provision contemplates two possible dates for triggering the statute of limitations — either "two years from the date on which the liability arises" if the actionable error was negligent, or "within two years after discovery by the individual of the [material] misrepresentation" if the information was "materially and willfully" withheld.[24]

The latter rule for willful misrepresentation is considered a "discovery" rule, and thus poses a threshold question of fact whenever the

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[21] *Id.* at § 1681t. The statute reads:

> This subchapter does not annul, alter, affect, or exempt any person subject to the provisions of this subchapter from complying with the laws of any State with respect to the collection, distribution, or use of any information on consumers, except to the extent that those laws are inconsistent with any provision of this subchapter, and then only to the extent of the inconsistency.

Id. See Leonard & Tidwell, *Consumer Credit Regulation: Is Federal Preemption Necessary?* 35 Bus. Law. 1291 (1980).

[22] State credit reporting laws are discussed in Annot., 12 A.L.R. 4th 294 (1982). *See also* Leonard & Tidwell, *supra* note 21, at 1295-1309 (concerning the problems created by dual legislation); Comment, *The New Commercial Speech and the Fair Credit Reporting Act,* 130 U. Pa. L. Rev. 131, 133 n.10 (1981) (listing several states which regulate consumer credit reporting).

[23] 15 U.S.C. § 1681h(e) (1982). The statute reads:

> . . . no consumer may bring any action or proceeding in the nature of defamation, invasion of privacy or negligence with respect to the reporting of information against any consumer reporting agency (or) any user of information . . . based on information disclosed pursuant (to the Act) except as to false information furnished with malice or willful intent to injure such consumer.

Id.

Section 1681h(e), however, limits state law negligence, privacy, and defamation actions based on reports disclosed under the FCRA to instances where false information is furnished with malice or willful intent to injure the consumer. 15 U.S.C. § 1681h(e). *See* Thorton v. Equifax, Inc., 619 F.2d 700 (8th Cir. 1980); Peller v. Retail Credit Co., 359 F. Supp. 1235 (N.D. Ga. 1973). The section does not apply when the consumer has not requested information through the FCRA. Two scholars nevertheless assert that "the Act effectively bars state actions in defamation and substitutes a statutory negligence action." Blair & Maurer, *Statute Law and Common Law*, 49 Mo. L. Rev. 289, 306 (1984). *See also* Note, *supra* note 2, at 1068 (§ 1681h(e) interferes with common law remedies). *See generally* Maurer, *Common Law Defamation and the Fair Credit Reporting Act*, 72 Geo. L.J. 95 (1983).

[24] 15 U.S.C. § 1681p. *See* Conf. Rep. No. 1587, 91st Cong., 2d Sess. *reprinted in* 1970 U.S. Code Cong. & Ad. News 4411, 4416.

statute of limitations defense is raised. That is, when did discovery occur? Such a rule is no more problematic in the FCRA context than in the common law of tort,[25] for discovery is essentially a clear factual issue. The real problem for the FCRA plaintiff is bringing suit within the time provided by the first statute of limitations, which is triggered by the act of negligence.

Liability for negligence arises upon the credit agency's use of "unreasonable procedures," but from a consumer's perspective, unreasonable procedures can be virtually impossible to prove. An inaccurate report, for example, is not a *per se* violation of the Act.[26] In order to show negligence, the consumer must not only prove the inaccuracy of the report, but also that the error resulted from the agency's inadequate procedures.[27] Furthermore, procedures resulting in error are not necessarily inadequate.[28] Instead, "[t]he standard of conduct by which the trier of fact must judge the adequacy of agency procedures is what a reasonably prudent person would do under the circumstances."[29] A credit reporting agency must simply follow "reasonable procedures to assure maximum *possible* accuracy of the information concerning the individual about whom the information relates."[30]

Given the difficulty of determining when liability for negligence arises, it becomes even more important to determine what date triggers the FCRA limitations period. According to the wording of the statute, the two-year period arguably runs from (1) the date of "actual unreasonableness" by the agency, (2) issuance of an erroneous report, (3) the date of whatever event might trigger the limitations period under state law, or (4) receipt of the credit agency's report.[31]

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[25]*See* RESTATEMENT (SECOND) OF TORTS § 899 comment e (1977).

[26]Bryant v. TRW, Inc., 487 F. Supp. 1234 (E.D. Mich. 1980), *aff'd*, 689 F.2d 72, 78 (6th Cir. 1982); Hauser v. Equifax, Inc., 602 F.2d 811, 814-15 (8th Cir. 1979). *See* Note, *Fair Credit Reporting*, 55 N.Y.U.L. REV. 111 (1980).

[27]*See* Koropoulos v. Credit Bureau, Inc., 734 F.2d 37, 41-42 (D.C. Cir. 1984).

[28]In fact, Blair & Maurer assert that "agencies produce a set level of negative information as a structural feature of their service, even though that tends to increase the incidence of false negative reports." Blair & Maurer *supra* note 23, at 294-95. They believe that this occurs in response to market pressure from the users of reports who wish to avoid false positive information, i.e., false information which understates the risk of making a loan. Nevertheless, the District of Columbia Circuit Court recently held that "[i]n certain instances, inaccurate credit reports by themselves can fairly be read as evidencing unreasonable procedures, and we hold that in such instances plaintiff's failure to present direct evidence will not be fatal to his claim." Stewart v. Credit Bureau, Inc., 734 F.2d 47, 52 (D.C. Cir. 1984).

[29]Thompson v. San Antonio Retail Merchant Ass'n, 682 F.2d 509, 513 (5th Cir. 1982), *quoted in* Bryant v. TRW, 689 F.2d 72, 78 (6th Cir. 1982).

[30]15 U.S.C. § 1681e(b) (1982)(emphasis added). *See also* 689 F.2d at 78.

[31]A fifth possibility — that discovery of the negligent error might trigger the time period — is excluded, because section 1681p does explicitly set out a discovery rule for willful acts. 15 U.S.C. § 1681p (1982). Some other occurrence must trigger the limitations period for negligent violations of the FCRA.

The first possibility, an actual unreasonableness test, would link liability to the unreasonable practices of the agency, regardless of the date of discovery or damage to the consumer. A slight modification of this approach was considered and rejected by a federal district court in *Lawhorn v. Trans Union Credit Information Corp.*[32] There, the plantiff complained of a series of violations which occurred more than three years prior to the time the suit was filed. Noting that the action had to be brought within two years from the date on which liability arose, the plaintiff argued that "liability allegedly arises from [the] defendant's system of reporting itself, rather than from individual instances of inaccurate information reported about plaintiff."[33] In essence, the plaintiff argued that the system of reporting employed by defendant constituted the "actual unreasonableness" of the agency, or the violation of the FCRA. The court disagreed, finding that liability only arose when the defendant failed to comply with the statute, and that the obligations imposed by the statute were "only in the context of the preparation of a consumer report."[34]

Thus, the court concluded, the preparation of an erroneous or incomplete consumer report was a prerequisite to an agency's liability under the FCRA and that the date the statute of limitations begins to run is the date a report is issued, *not* the date the agency actually employs any unreasonable procedures.[35] If the unreasonable system of reporting or procedures had been the test, a plaintiff's actionable claim might begin and lapse without her knowledge.[36] Moreover, because the actual unreasonableness test would trigger questions regarding both the statute of limitations and the defendant's liability, the proposed test would mandate a hearing on the merits of plaintiff's claim each time a statute of limitations defense was asserted. Arguably then, the *Lawhorn* court rejected the actual unreasonableness test on grounds of fairness and practicality.

It appears that the *Lawhorn* court employed the second possible test—issuance of an erroneous credit report. After noting that the FCRA imposes "obligations only in the context of the preparation of a consumer report,"[37] the court relied on the unpublished opinion of *Kaufman v. Trans Union Systems Corp.*[38] to rule that "the date of the report would signal the beginning of the running of the statute of limitations."[39] The

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[32]515 F. Supp. 19 (E.D. Mo. 1981)(mem.).

[33]*Id.* at 20.

[34]*Id.* (emphasis added).

[35]*Id.* (quoting Kaufman v. Trans Union Sys. Corp., No. 80-1218C(3), slip op. at 4 (E.D. Mo. 1981)).

[36]In this case plaintiff had alleged a continuing violation by the defendent and thus sought to recover for violations allegedly occurring outside of the two-year limitations period.

[37]515 F. Supp. at 20.

[38]No. 80-1218C(3), slip op. (E.D. Mo. 1981).

[39]515 F. Supp. at 20 (quoting Kaufman, slip op. at 4).

opinion presents no more than a bare conclusion, but the conclusion could be supported by factors which the *Lawhorn* court failed to identify. For example, the date a credit report is issued is easily ascertainable and thus has at least some relevance to the plaintiff's damages. This approach also comports with the remedial purpose of the FCRA in that it does not foreclose a party's rights before he or she has had an opportunity to detect a violation, because at the time of issuance, any error or negligence is at least susceptible of discovery.

A closer examination reveals that another explanation for the *Lawhorn* decision can be drawn from the circumstances. It appears the *Lawhorn* court may not have actually adopted the issuance test. Rather, the court could just as easily have been relying on the third approach enunciated above—using the event that triggers the statute of limitations under state law. Under Missouri law, for example, the applicable statute of limitations for libel begins to run upon issuance of the defamatory statement.[40]

A state-by-state approach, however, could have chaotic results. In *Wilson v. Retail Credit Co.*,[41] for example, the Fifth Circuit Court of Appeals considered an action for libel arising from information in a Mississippi credit report. A one-year statute of limitations governs libel suits in Mississippi. The plaintiff filed suit on November 25, 1969, for a credit report issued in September, 1963. Relying on Mississippi libel law, the court stated that "[i]f any claim arose or accrued on this report, it did so when the report was received by defendant's customer . . . ."[42] The plaintiff's suit was barred, as the report had been received many years before.

The claim brought before the *Wilson* court was for libel and resulted from the allegedly defamatory content of the credit report. If the plaintiff had sued for an invasion of privacy, the limitations period might have differed. If courts apply state law, each FCRA suit in every state will be governed by a different statute of limitations, depending on the underlying common law claim and the individual state's applicable limitations period.

This result is in conflict with the federal statutory scheme, for the FCRA provides its own statute of limitations period[43] and anticipates that all FCRA claims will be governed by its provision. Arguably, Congress intended to consolidate those suits which arise from credit reports, regardless of the underlying claim, and provide consumers with the right to sue under the FCRA in addition to pursuing any state law

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[40]White v. Fawcett Publications, 324 F. Supp. 403, 404-05 (W.D. Mo. 1971). *See also* Mo. Ann. Stat. § 516.140 (Vernon Supp. 1985). Often in states where the statute of limitations is triggered by receipt of the libelous or defamatory material, the receipt test has been utilized by federal courts. *See, e.g.*, Wilson v. Retail Credit Co., 438 F.2d 1043, 1045 (5th Cir. 1971) (Relying on Mississippi law, the court held that the statue of limitations did not begin to run until the credit report was received by the consumer.).

[41]438 F.2d 1043 (1971).

[42]*Id.* at 1045.

[43]15 U.S.C. § 1681p.

claims.[44] The fact that publication or receipt is the law in the forum state should not be determinative of the federal claim. As section 1681t intimates, the FCRA does not duplicate or preempt state law, but rather provides an alternative method of regulation and enforcement.[45]

If state law is not determinative, the problem of what event should trigger the FCRA's statute of limitations remains. The common law of commercial defamation, an analogue of the FCRA,[46] is a persuasive source of rules to fill the gaps in the ill-designed federal statute. Such an analogy suggests that the fourth interpretation enumerated above—receipt of the credit report—should trigger the FCRA limitations period.

In general, defamation is the publication of anything injurious to the good name or reputation of another, or which tends to bring him into disrepute.[47] In a typical defamation suit, the statute of limitations runs from the time of publication.[48] Before publication, the defamation is not complete because the matter has not been made public or been disseminated in some way.

Given this analogy, a credit report is not complete until it is published and disseminated to a lending institution.[49] Information stored on computer software does not constitute a report until someone asks for a readout, for the contents of the report will not be discovered absent some communication. Therefore, damages do not arise until the report is communicated to a potential lender, affecting the borrower's finances, reputation, or peace of mind.

Congressional debates surrounding the FCRA emphasize the link between adverse publication and harm to consumers. Representative Sullivan, the House sponsor of the bill, expressly considered in her remarks to Congress that the FCRA would provide a federal remedy for commercial defamation. "The loss of a credit card can, of course, be expensive, but, as Shakespeare said, the loss of one's good name is beyond price and makes one poor indeed. This bill's Title VI deals with

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[44] *Id.* at § 1681t.

[45] *Id. See generally* Blair & Maurer, *supra* note 23 at 301-06.

[46] *See* Maurer, *supra* note 23, at 97. Often, both common law defamation and violation of the FCRA are combined in one suit. In Wright v. TRW Credit Data, 588 F. Supp. 112 (S.D. Fla. 1984), the plaintiff charged that "as a result of the credit bureaus' poor reports the plaintiff has been defamed . . . ." *Id.* at 113. *But cf.* Note, *supra* note 2, at 1035 ("attempts to gain judicial relief [from credit reports] have been stymied by an inappropriate application of the defamation doctrine").

[47] *See* BLACK'S LAW DICTIONARY 375-76 (5th ed. 1979). *See generally*, Note, *supra* note 2 at 1049-54.

[48] *See* Lashlee v. Sumner, 570 F.2d 107, 109 (6th Cir. 1978); New York Times Co. v. Conner, 291 F.2d 492, 494 (5th Cir. 1961); Annot., 42 A.L.R. 3D 807 (1972). (There is no controversy at all that the statute of limitations commences to run from the time of publication of a libel.)

[49] *See* Koropoulos v. Credit Bureau, Inc., 734 F.2d 37 (D.C. Cir. 1984). The court found that "these provisions [of the FCRA] allow consumers to bring suit for a violation of section 1681e(b) only if a credit reporting agency issues an inaccurate report on the consumer, since only then does harm flow from the agency's violation." *Id.* at 39 (footnote omitted).

that problem."[50] Representative Wylie of Ohio added that "many people who are [harmed by credit reporting errors] are unaware of the fact that misinformation in a credit report has harmed them."[51] The reported debates indicate that Congressional supporters of the FCRA were aware of, and concerned with, the *actual circulation* of harmful credit information.[52]

"[T]ime limitations . . . themselves promote important interests . . . ."[53] According to the United States Supreme Court, "the period allowed for instituting suit inevitably reflects a value judgment concerning the point at which the interests in favor of protecting valid claims are outweighed by the interests in prohibiting the prosecution of stale ones."[54] In the consumer-oriented FCRA context, the interest in protecting valid claims, and thereby checking the power of credit agencies, is great.[55] The receipt test maximizes the number of claims which fall within the language of the FCRA limitations provision without significantly increasing the danger of stale claims. In addition, this approach draws support from the legislative record[56] and the commercial defamation analogy earlier drawn,[57] which stipulates that publication is complete upon receipt of the credit report. The cause of action should therefore

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[50]116 CONG. REC. 36,570 (1970). The court in Partida v. Warren Buick, Inc., 454 F. Supp. 1366 (N.D. Ill. 1978), reached a similar conclusion when considering the statute of limitations governing a closed end credit transaction. In a case arising under the Trust in Lending Act, 15 U.S.C. §§ 1601-64, 1661-65, the court ruled that the limitations period ran from the date defendant violated the Act's disclosure requirements rather than the date that the credit contract was consummated. *Id.* at 1370-71. *See also* Davis v. Edgemere Finance Co., 523 F. Supp. 1121, 1123 (D. Md. 1981). A closed end credit plan is one where the full amount of indebtedness is set at the time of contracting. *Partida*, 454 F. Supp. at 1370 n.3. An open end credit plan has been defined as

> [o]ne in which credit terms are initially established with the opening of the account, but no fixed amount of debt is incurred at the time. Purchases made from time to time are added to the outstanding balance in the account and each new purchase represents an additional extension of credit under the terms as originally defined in the credit agreement.

Goldman v. First National Bank, 532 F.2d 10, 17 n.11 (7th Cir. 1976), *quoted in Partida*, 454 F. Supp. at 1370 n.3.

[51]116 CONG. REC. 36,574 (1970).

[52]116 CONG. REC. 35,575-76 (1970).

[53]Delaware State College v. Ricks, 449 U.S. 250, 259 (1980).

[54]Johnson v. Railway Express Agency, 421 U.S. 454, 463-64 (1975), *quoted in* Delaware State College v. Ricks, 449 U.S. at 259-60 (an employment discrimination case).

[55]Blair and Maurer argue that in the courts, the respective interests of consumers and the credit industry are asymmetric and that over time "the rules will develop so as to favor the industry, the party with the ongoing interest." Blair & Maurer, *supra* note 23, at 306. They further conclude that the requirements of the FCRA have constrained industry attempts to return to the inefficient common law standards which protected credit agencies from liability through the doctrine of "qualified privilege." *Id.* at 306-08. *See infra* note 79 (qualified privilege defined).

[56]*See supra* notes 50-52.

[57]*See supra* notes 47-50 and accompanying text.

accrue, and the statute of limitations begin to run, the moment the potential lender receives the credit agency report.[58]

III. Can Consumers Recover from a Continuing Violation?

Mr. Smith's problem is not entirely resolved by the adoption of the receipt test. Smith's lenders received his credit report in 1981, 1982, and 1984. The suit was filed in 1985. The 1984 incident is well within the limitations period, but claims on the earlier reports appear to be barred.

Suppose, however, that Mr. Smith argues that the error appearing in the 1984 report was a continuing error which originated in 1981. In some instances, courts have allowed recovery for actionable failures occurring outside the applicable limitations period if there is continuity between the past and present illegal acts.[59] When a continuing violation is established, the filing period would be measured from the date of the last violation, not the first.[60]

The FCRA is itself silent on the applicability of a continuing violation theory to FCRA suits. In the only reported opinion to consider the issue in the FCRA context, the court found that the continuing violation theory was not applicable.[61] In *Lawhorn v. Trans Union Credit Information Corp.*,[62] the court was asked to determine when the date of liability arose for the purposes of the statute of limitation.[63] The court rejected the plaintiff's argument that the liability arose as a result of defendant's system, and determined (arguably) that liability arises upon the publication of an erroneous report. However, the *Lawhorn* court construed (and then rejected) the plaintiff's contention as a continuing violation argument. The plaintiff, rather, was simply arguing that liability arose as the result of a defective system, not any individual actions. Thus, the question of continuing violation when the error is identical year after year remains open.

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[58]According to the Restatement (Second) of Torts, "[a] cause of action for misrepresentation in a business transaction is complete when the injured person has been deprived of his property or otherwise has suffered pecuniary loss or has incurred liability as a result of the misrepresentation." Restatement (Second) of Torts § 899 comment c (1979). Placed in the context of credit reports, this should be when the potential lender receives the inaccurate credit report. The FCRA, on the other hand, provides that the cause of action accrues at the time "liability arises," 15 U.S.C. § 1681p, and that liability arises when the agency employs unreasonable procedures. *See* 15 U.S.C. § 1681o.

[59]*See* Shehadeh v. Chesapeake & Potomac Tel. 595 F.2d 711, 724 (D.C. Cir. 1978). When "the ongoing program of discrimination, rather than any of its particular manifestations, . . . is the subject of attack, a complaint may be timely filed, even if acts occurring outside the limits are included. Rinkel v. Associated Pipeline Contractors, 17 F.E.P. 224 (D.C. Alaska 1978) (each discriminatory paycheck renews statute of limitations).

[60]Shehadeh v. Chesapeake & Potomac Tel. Co., 595 F.2d at 724 (footnote omitted).

[61]Lawhorn v. Trans Union Credit Information Corp., 515 F. Supp. 19, 20 (E.D. Mo. 1981).

[62]515 F. Supp. 19.

[63]*See* text accompanying notes 32-36.

At least one court has seemingly recognized a continuing violation theory. In *Polin v. Dun & Bradstreet, Inc.*,[64] a credit reporting suit alleging violations of the FCRA by a state credit regulatory scheme, the Tenth Circuit Court of Appeals recognized that the "defendant's conduct was . . . continuing in its nature and character. Hence, the damages flowing from the defendant's conduct would, under such a theory, not fully accrue until the final publication."[65] In *Polin*, misleading information was published initially and then republished on two later occasions. The court of appeals, in remanding the case, indicated that the lower court should not wholly disregard the first two publications.[66]

The continuing violations theory is not the norm in tort law, which generally limits the recovery period as a matter of fairness to potential defendants. A form of the theory is, however, a minority position in the common law of libel, and thus retains some vitality in state law.[67]

Furthermore, a similar application of the continuing violations doctrine has been entertained in the context of the Truth in Lending Act (TILA).[68] The general rule is that in cases involving closed end consumer credit transactions, the limitation period begins to run at a specific time—either at the time of execution of the credit contract or at the time the contract is performed. However, when the action is instituted more than one year after execution of the loan contract but less than one year after the actual extension of credit, some courts have found that the creditor's nondisclosure constitutes a continuing violation until the date when credit is extended.[69] In one such case, the District of Columbia District Court concluded that the continuing violations theory was applicable because the Act was intended to assist and inform the consumer,[70] the defendant's misconduct could best be characterized as

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[64]511 F.2d 875 (10th Cir. 1975).

[65]*Id.* at 878.

[66]*Id.*

[67]The so-called "multiple publication" rule is that each repetition of a libel constitutes a separate and distinct publication giving rise to a cause of action. It has been abandoned in many jurisdictions in favor of the "single-publication" rule, but is still followed by courts in Wisconsin and Montana. *See* Hartmann v. American News Co., 69 F. Supp. 736, 738 (D.C. Wis. 1947); Lewis v. Reader's Digest Ass'n, Inc., 512 P.2d 702, 703 (Mont. 1973).

[68]15 U.S.C. §§ 1601-44, 1661-65. The statutory limitations period provides, "Any action under this section may be brought in any United States District Court, or in any other court of competent jurisdiction, within one year from the date of the occurrence of the violation." 15 U.S.C. § 1640e. Closed end and open end credit transactions are defined *supra* note 50. *See generally* Annot., 36 A.L.R. FED. 657 (1978) (time limitations under the TILA).

[69]Postow v. Oriental Bldg. Ass'n, 390 F. Supp. 1130, 1137-39 (D.D.C. 1975), *aff'd in part*, 627 F.2d 1370, 1379-80 (D.C. Cir. 1980); Baker v. Shaker Savings Ass'n, Consumer Credit Guide (CCH) ¶ 98794 (D.C. Ohio 1974). *Compare* Goldman v. First National Bank, 532 F.2d 10 (7th Cir. 1976) (continuing violation not applicable to open end credit transactions).

[70]390 F. Supp. at 1139, 627 F.2d at 1378-79.

a continual deprivation of the plaintiffs' statutory rights,[71] and the harm to the plaintiffs continued through the duration of the defendant's violation.[72]

The rationale for continuing violations in the civil rights and TILA closed credit cases leads to the same result in the FCRA context. Like Title VII and the TILA, the FCRA provides a framework parallel to but separate from common law tort, and gives rise to different limitations considerations.

First, the FCRA is admittedly consumer-oriented,[73] yet was drafted to promote out-of-court settlement of credit disputes.[74] The purposes of the FCRA are thwarted when the consumer, who has jumped over all of the procedural hurdles of sections 1681g-1681l[75] and has still failed to correct the error being reported, is barred from a civil suit simply because his conciliatory efforts took too long. Failure neither to toll the statute of limitations during the negotiation period[76] nor to allow recovery for continuing violations rewards the credit reporting agency for ignoring the consumer's efforts until after the statute of limitations period has expired. Ideally, liability for these recurring inaccuracies will increase the credit industry's costs for such inaccuracies. These high costs may then encourage the implementation of reasonable procedures to eliminate

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[71]390 F. Supp. at 1139.

[72]*Id.* The *Postow* court found cases dealing with continuing violations in other areas of the law to be particularly persuasive evidence of the theory's validity in the TILA context, and cited the following analogies: Hanover Shoe v. United Shoe Machinery Corp., 392 U.S. 481, 502 n.15 (1968) (continuing violation in private antitrust suit); Katz v. NLRB, 196 F.2d 411, 415 (9th Cir. 1952) (continuing unfair labor practice); Schokbeton Products Corp. v. Exposiac Industries, Inc., 308 F. Supp. 1366, 1367-68 (N.D. Ga. 1969) (continuing antitrust violation). *See Postow*, 627 F.2d at 1379-80.

[73]When speaking to the House of Representatives in support of the Conference Report on H.R. 15,073 containing the FCRA, Representative Sullivan stated, ". . .we assured the individual a means through court action to get to the bottom of any charge against him which he cannot refute without knowing where it came from. And we succeeded in making the reporting firms liable for damages for harm done by the firm's own negligence." 116 CONG. REC. H10,049 (1970). *See, e.g.*, 15 U.S.C. § 1681(a)(4). One commentator writes that the Act

> . . . is a remedial statute whose purpose is to break through a mist of secrecy which surrounded many of the reports which determine whether an individual will attain sought-after benefits, and to provide effective recourse against errors in those reports. Such a remedial statute, in the absence of clear conflict with congressional intent, merits a liberal, rather than a painfully strict, construction. . . .

Note, *Judicial Construction*, *supra* note 5, at 485.

[74]15 U.S.C. §§ 1681g, 1681h, and 1681i, state the rules for disclosure of information to consumers and create a procedure through which the consumer can dispute a report's accuracy.

[75]*Id.*

[76]Blair & Maurer's work suggests that such tactics would likely result from credit reporting industry attempts to circumvent the symmetrical responsibilities imposed by the FCRA on consumer and reporting agency alike. Blair & Maurer, *supra* note 23, at 295-96.

these reporting errors in the first instance,[77] realizing the objectives of the FCRA.

Second, a continuing violation in a credit report is literally the present manifestation of a past wrong.[78] For example, if a credit reporting agency is shorthanded and has to forego checking the accuracy of its information, false, unverified reports might be typed onto a computer and issued to potential lenders. In the time between each issuance, the information would lie dormant in a computer bank. Here, the past wrong or violation is the "unreasonable procedure" of failing to verify reports, and this past wrong is manifested in the present each time the same erroneous information is reissued in a credit report.

Finally, enabling a consumer to sue for continuing violations does not alter the rules of qualified privilege[79] nor skew the burdens set out in the FCRA.[80] The standard of proof for unreasonable procedures under

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[77]The cost of erroneous reports, and the expense of avoiding error, are termed "primary accident costs" by G. CALABRESI, in THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970). Primary costs should be borne by the "cheapest cost avoider," *id.* at 143-73, the party which can best assign the costs to the harm-causing activity, predict the costs most accurately, and insure against them most cheaply. *Id.* Concluding that in the credit reporting context, the reporting agency can best assume primary costs, one author writes

> . . . [t]he credit reporting bureau is thus able to assign the cost which the subject cannot, to evaluate the costs more accurately than the subject can, and to insure against them at lower cost. The bureau would be the cheapest avoider of primary costs, and imposing the cost on it would achieve the best general deterrence.

Note, *supra* note 2, at 1044-45.

[78]This is the argument the respondent made in United Air Lines v. Evans, 431 U.S. 553 (1977). There, the plaintiff argued in favor of adopting a continuing violation theory, but the United States Supreme Court stated that "the emphasis should not be placed on mere continuity; the critical question is whether any present *violation* exists." 431 U.S. at 558 (emphasis in original).

[79]Traditionally, under defamation principles, plaintiffs had to prove actual malice to recover from consumer reporting agencies. Under this doctrine, agencies are given a "qualified privilege" from liability for reports which would otherwise be defamatory. *See* Smith, *Conditional Privilege for Mercantile Agencies* — Macintosh v. Dun, 14 COLUM. L. REV. 187 (1914); Harper, *Privileged Defamation*, 22 VA. L. REV. 642 (1936); Note, *supra* note 2, at 1049-54. Qualified privilege is a "conditional privilege . . . recognized in many cases where the publisher and the recipient have a common interest, and the communication is of a kind reasonably calculated to protect or further it." W. PROSSER, THE LAW OF TORTS, at 789 (4th ed. 1971). A publication is considered privileged "when it is 'fairly made by a person in the discharge of some public or private duty, whether legal or moral . . . .' " *Id.* at 786 (footnote omitted). The privilege is generally accorded to mutual credit rating organizations because "such agencies perform a useful business service for the benefit of those who have a legitimate interest in obtaining the information, and who request the agency to obtain it for them." *Id.* at 790 (citations omitted). The privilege currently persists only to the extent that individual states still follow the rule. Maurer, *supra* note 23, at 101-05. *See, e.g.*, Tom Oleskeer's Exciting World of Fashion, Inc. v. Dun & Bradstreet, Inc., 61 Ill.2d 129, 137, 334 N.E.2d 160, 164 (1975).

[80]Courts generally assume that the burden of proving reasonableness of procedures followed falls on the plaintiff. *See* Hauser v. Equifax, 602 F.2d 811, 814-15 (8th Cir. 1979); Morris v. Credit Bureau, 563 F. Supp. 962, 968 (S.D. Ohio 1983); Alexander v. Moore & Assoc., Inc., 553 F. Supp. 948, 954 (D. Haw. 1982). *See also* Note, *Panacea or Placebo? Actions for Negligent Noncompliance Under the Federal Fair Credit Reporting Act,* 47 S. CAL. L. REV. 1070, 1105-09 (1974).

the FCRA involves a balancing test. "[T]he court, in determining whether a violation of § 1681e(b) has occurred, would weigh the potential that the information will create a misleading impression against the availability of more accurate [or complete] information and the burden of providing such information."[81] This standard must be met, and the failure must be fairly attributable to negligence or malice before the plaintiff can recover for erroneous credit reports.[82] Allowing claims for continuing violations does not alter this standard but enables a consumer to pursue out-of-court remedies without forfeiting his or her right to relief under the FCRA.

IV. Conclusion

With the FCRA, Congress has attempted to balance the interests of consumers and consumer reporting agencies. The FCRA requires that specific information be made available to the subjects of credit reports and that agencies implement procedures for a consumer to dispute a report's accuracy. Furthermore, consumers have the opportunity to recover report-related damages by filing suit.

As a result of poor drafting, courts hearing complaints that involve the FCRA's statute of limitations must consider two important questions before arriving at a decision: (1) what event triggers the limitations period for negligent error; and (2) does the FCRA allow recovery for damages from a "continuing error?" Courts should attempt to resolve these questions by referring to the purposes of the FCRA and the common law underlying its provisions.

The law of defamation, which is analogous to the theory of the FCRA, suggests that receipt of the consumer report triggers the statute of limitations for negligent error.[83] Discovery of the error, or the date that damage arises, is unavailable as an accrual date under the terms of the Act. Other possibilities, such as the date of the report's issuance, or the time that unreasonable procedures were employed, are impractical and do not comport with the accepted legal doctrine governing defamatory publications.

There is room under the FCRA for the continuing violation theory. The continuing violations theory is not new to tort law, and the "multiple publication" theory used in defamation cases is a position to which many states subscribe. Lifting the continuing violations theory from other more popular contexts does no damage to the concept itself, nor does it skew the burdens set out in the FCRA. The FCRA shares a consumer orientation with other laws, and agency liability for continuing violations would probably minimize such violations.

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[81]553 F.Supp. at 952. This standard was adopted by the Circuit Court of Appeals for the District of Columbia in Koropoulos v. Credit Bureau, Inc., 734 F.2d 37, 42 (D.C. Cir. 1984).

[82]15 U.S.C. § 1681p.

[83]*See supra* text accompanying notes 46-49.

Third Party Insurer Liability in Title VII Discrimination Actions: A Resolution Against Liability

I. Introduction

In 1983, the United States Supreme Court granted certiorari to three very similar cases,[1] all of which presented for the first time the issue of whether or not a group annuity plan operated by an independent third party insurer may be discriminatory under Title VII.[2] The plaintiffs in each case alleged that they were being discriminated against because the annuity plans in question calculated payment schedules on the basis of sex-segregated mortality tables.[3]

Two of the cases, *Spirt v. Teachers Insurance and Annuity Association* (TIAA)[4] and *Peters v. Wayne State University*,[5] differed from the third, *Arizona Governing Committee v. Norris*,[6] in one important

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[1]Spirt v. Teachers Ins. & Annuity Ass'n, 691 F.2d 1054 (2d Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983), *on remand*, 735 F.2d 23 (2d Cir. 1984); Peters v. Wayne State Univ., 691 F.2d 235 (6th Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983); Arizona Governing Comm. v. Norris, 103 S. Ct. 3492 (1983).

[2]42 U.S.C. §§ 2000e to 2000e-17 (1982). Title VII provides in pertinent part: "It shall be an unlawful employment practice for an employer . . . to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment because of such individual's race, color, religion, sex, or national origin . . . ." 42 U.S.C. § 2000e-2(a).

[3]The basis of the alleged discrimination in each of the three cases was the employer's (or insurer's) use of mortality tables that placed men and women in different actuarial classes. These different classifications were used because women, as a class, live longer than men. Because of the different life expectancy, women, as a class, were expected to receive a greater number of monthly payments than their male counterparts. Thus, women received lower monthly payments than would a man of the same age making the same financial contribution.

A related issue was decided in Los Angeles Dep't of Water & Power v. Manhart, 435 U.S. 702 (1978). In *Manhart*, the United States Supreme Court found that an employer-operated pension fund was discriminatory because the employer, based on sex-segregated mortality tables, required women to make greater contributions in order to receive monthly payments equal to those of the men.

The question whether or not these classifications should be deemed discriminatory, a question beyond the scope of this Note, has been discussed in numerous cases and articles. *See, e.g.*, Arizona Governing Comm. v. Norris, 103 S. Ct. 3492; Benston, *The Economics of Gender Discrimination in Employee Fringe Benefits:* Manhart *Revisited*, 49 U. Chi. L. Rev. 489 (1982); Note, *TIAA-CREF and the Sex-Based Mortality Table Controversy*, 7 Coll. & U. L. 119 (1980-81); Note, *Challenges to Sex-Based Mortality Tables in Insurance and Pensions*, 6 Women's Rts. L. Rep. 59 (1979-80).

[4]691 F.2d 1054 (2d Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983), *on remand* 735 F.2d 23 (2d Cir. 1984).

[5]691 F.2d 235 (6th Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983).

[6]103 S. Ct. 3492.

respect. In addition to seeking redress against their actual employers, the plaintiffs attempted to establish liability on the part of the third party insurers that administered the plans.[7] Both *Spirt* and *Peters* involved the same insurer[8] and annuity plan, yet the courts reached opposite results. In *Spirt*, the Second Circuit Court of Appeals found that the insurer was "so closely intertwined with [the plaintiff's employer] that [the insurer] must be deemed an 'employer' for purposes of Title VII."[9] The opposite conclusion was reached in *Peters*, where the Sixth Circuit held that the insurer could not be liable because the insurer was neither the plaintiffs' employer nor an agent of Wayne State University.[10]

In addition to the issues of liability as an "agent" or "employer" under Title VII, both *Spirt* and *Peters* raised the question of the impact of the McCarran-Ferguson Act (MFA)[11] on the insurers' liability.[12] The *Spirt* court rejected the insurers' MFA defense,[13] and the *Peters* court found it unnecessary to address the issue in light of its initial determination of no liability.[14]

Of the three cases granted certiorari, the Supreme Court rendered an opinion only in *Arizona Governing Committee v. Norris*,[15] the one case that did not raise the issues concerning an insurer's liability.[16] *Spirt* and *Peters* were both vacated and remanded "for further consideration in light of [*Norris*]."[17] On remand, the conflict with respect to insurer liability was not resolved. The Second Circuit did not change its position regarding TIAA's liability;[18] and although the *Peters* decision has not been reported on remand, the Sixth Circuit subsequently maintained its view that insurers are not liable under Title VII in *EEOC v. Wooster Brush Employees Relief Association*.[19]

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[7]The plaintiffs in both *Spirt* and *Peters*, in addition to suing their respective universities, sued TIAA and CREF. TIAA and CREF are companion nonprofit insurance corporations which deal exclusively with some 2,800 colleges and universities and their employees. *See, e.g.*, *Spirt*, 691 F.2d at 1057.

[8]*See supra* note 7.

[9]691 F.2d at 1063. The court held that the annuity plan was discriminatory and that the plaintiff's employer, Long Island University, was also liable for the discrimination.

[10]691 F.2d at 238. The court characterized the district court's finding that the insurer was an "employer" as "clearly erroneous." *Id.*

[11]15 U.S.C. §§ 1011-1015 (1982).

[12]The McCarron-Ferguson Act (MFA), passed by Congress in 1947, exempts the "business of insurance" from the effect of any federal statute that does not "specifically [relate] to the business of insurance." *Id.* § 1012(b).

[13]691 F.2d at 1065.

[14]691 F.2d at 241. The issue of MFA exemption was addressed by the district court in *Peters* and the defense was rejected. 476 F. Supp. 1343, 1350-51 (E.D. Mich. 1979), *rev'd*, 691 F.2d 235 (6th Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983).

[15]103 S. Ct. 3492.

[16]The plan in *Norris* was administered by Lincoln National Life Insurance Company. Lincoln Life was not joined in the suit. *Id.* at 3495.

[17]*Spirt*, 103 S. Ct. at 3565-66; *Peters*, 103 S. Ct. 3566.

[18]*Spirt*, 735 F.2d 23 (2d Cir. 1984).

[19]727 F.2d 566 (6th Cir. 1984). *Wooster Brush* differed from *Peters* and *Spirt* in that the discrimination alleged was the failure to provide pregnancy disability benefits. The essential issues of "employer" or "agent" status and MFA immunity, however, were the same.

These conflicting decisions have created uncertainty regarding the liability of independent third party insurers in Title VII litigation. This Note will examine the reasoning which has guided the courts in their decisions as to whether or not an insurer may be an "employer" or "agent" of an employer for purposes of Title VII. An analysis of the possible theories that might support the insurer's status as "agent" or "employer" will illustrate that the position favoring insurer non-liability is more firmly based in law and reason. In addition, the Note will explore the impact of the McCarran-Ferguson Act on insurer liability. The Note will demonstrate that all questions of insurer liability under Title VII should be precluded by the Act.

II. The Insurer As Employer or Agent

A. The Policy Considerations of Title VII

Title VII was enacted as part of the Civil Rights Act of 1964, a comprehensive series of statutes established for the purpose of eliminating to the extent possible the essential inequities resulting from widespread discrimination in American society.[20] Congress had come to the realization that the rights of citizenship alone were not sufficient guarantees of freedom in this country. The legislators recognized that "[t]he rights of citizenship mean little if an individual is unable to gain the economic wherewithall to enjoy or properly utilize [those rights]."[21] Thus, Title VII was enacted to guarantee every citizen equal employment opportunities by proscribing discrimination by an "employer"[22] or any "agent"[23] of an employer against any individual on the basis of sex, race, color, religion, or national origin.[24]

The broad scope of Title VII[25] and the important remedial purposes it was intended to effect have led many courts to recognize that the

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[20]H.R. Rep. No. 914, 88th Cong., 1st Sess. (1963).

[21]*Id.*

[22]42 U.S.C. § 2000e(b). The term "employer" is defined in the Act as "a person engaged in an industry affecting commerce who has fifteen or more employees for each working day in each of twenty or more calendar weeks in the current or preceding calendar year." *Id.*

[23]*Id.* The term "agent" is given no specific definition in the statute. *See infra* text accompanying notes 44-67.

[24]42 U.S.C. § 2000e-2(a).

[25]The pervasive scope of the policy behind Title VII is also illustrated by the very limited exceptions to the rules against discriminatory employment practices, the "bona fide occupational qualification" (BFOQ) exception and the "Bennent Amendment." The BFOQ exception allows an employer to hire his employees on the basis of religion, sex, or national origin in the few instances that such criteria are "bona fide occupational qualification[s] reasonably necessary to the normal operation of that [employer's] particular business or enterprise." 42 U.S.C. § 2000e-2(e). The Bennent Amendment allows different compensation between the sexes if such differentiation is authorized by the Equal Pay Act. *Id.* § 2000e-2(h). The Equal Pay Act allows different compensation only when the difference is the result of a seniority system, a merit system, a system which measures compensation by quantity or quality of production, or any factor other than sex. 29 U.S.C. § 206 (1982). *See* Note, *Title VII and the McCarran Act: Sex Discrimination in Retirement Benefits by Third-Party Insurers*, 68 Geo. L.J. 1285, 1293 (1979-80).

language of the Act should be liberally construed.[26] "Liberal" interpretation, however, has its limits, and some courts have exceeded these limits in the context of insurer liability under Title VII. Specifically, the terms "employer" and "agent" of section 2000e-2(a) have been interpreted in ways that create new definitions for the terms unwarranted by prior law, history, or reason.

Section 2000e-2(a) of Title VII is designed to effect Title VII's purposes through the proscription of certain employment practices by an "employer" or "any agent of such a person."[27] Therefore, unless a person charged with a violation of this section can be brought within the definition of employer or agent of an employer, such person can incur no liability for a violation of Title VII. Hence, the initial and most critical step in any section 2000e-2(a) action is the determination of whether or not the party charged fits within the definitions of these terms.

Unfortunately, many courts have been less than clear in their analyses of who is an "employer" or "agent" of an employer for purposes of Title VII. In very sketchy expositions, courts have used the term "employer" when the actual considerations seem to indicate some sort of agency relationship, and have applied the term "agent" when an employer analysis is apparently being used.[28] The courts themselves are seemingly unsure of the exact relationship they are attempting to establish.

B. Liability Under Spirt

One of the major cases finding insurer liability under Title VII is *Spirt v. Teachers Insurance and Annuity Association*.[29] In *Spirt*, the plaintiff, a professor at Long Island University, brought an action against the university and TIAA,[30] alleging that the defendants had violated section 2000e-2(a) of the Civil Rights Act of 1964[31] by using sex-segregated mortality tables in determining annuity rates for university employees.

The district court held that the TIAA was an "employer" within the meaning of that term as used in Title VII.[32] In so holding, the court explained that the remedial purposes of Title VII require a definition of "employer" which is broader than that which the term normally connotes. The court stated that the term "employer" "encompass[es]

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[26]*E.g.*, *Spirt*, 691 F.2d at 1063 and cases cited therein.

[27]42 U.S.C. § 2000e(b). *See also supra* notes 22-23.

[28]*See infra* text accompanying notes 32-39.

[29]691 F.2d 1054 (2d Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983), *on remand*, 735 F.2d 23 (2d Cir. 1984).

[30]Also sued with TIAA was College Retirement Equity Fund (CREF), a companion corporation of TIAA. TIAA provided variable annuities while CREF provided fixed annuities.

[31]*See supra* text accompanying notes 22-24.

[32]*Spirt*, 691 F.2d at 1057. TIAA is a nonprofit legal reserve life insurance company which provides retirement benefits to over 400,000 employees at more than 2,800 colleges and universities. *Id.*

persons who are not employers in conventional terms, but who nevertheless control some aspect of an individual's compensation, terms, conditions, or privileges of employment."[33] Finding that Long Island University and other colleges and universities "delegated their responsibility [sic] for and control over employee annuity plans to TIAA,"[34] the court concluded that if TIAA were not held liable, the discrimination could not be fully remedied; therefore, the effectiveness of Title VII would be impaired.[35] The court then stated that it was significant that TIAA is a nonprofit corporation "whose sole reason for existence is to serve Spirt's direct employer, LIU, and other similar institutions by relieving them of the burden of establishing and administering their own insurance programs . . .and that participation in TIAA . . . is compulsory for plaintiff as a tenured professor."[36]

The Second Circuit approved this reasoning summarily:

> We agree with the district judge that TIAA and CREF, which exist solely for the purpose of enabling universities to delegate their responsibility [sic] to provide retirement benefits for their employees, are so closely intertwined with those universities, (in this case LIU), that they must be deemed an "employer" for purposes of Title VII. It is also relevant that participation in TIAA-CREF is mandatory for tenured faculty members at LIU, and that LIU shares in the administrative responsibilities that result from its faculty members' participation in TIAA-CREF.[37]

In addition, both the district court and the court of appeals attempted to bolster their rationales with reference to a statement made by the United States Supreme Court in *Los Angeles Department of Water and Power v. Manhart*:[38] "We do not suggest, of course, that an employer can avoid his responsibilities by delegating discriminatory programs to corporate shells. Title VII applies to 'any agent' of a covered employer . . . ."[39]

Although the reasoning of these courts may appear logical at first blush, closer analysis reveals that the argument is fraught with contradiction and difficulty. At the outset, it is not clear why it is "significant" or "relevant" that the TIAA-CREF plans are mandatory for tenured professors. The decision regarding whether or not participation was compulsory was that of the employer, the university, and not the insurer. TIAA and CREF are not shown to have held any positions of authority

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[33]*Spirt*, 475 F. Supp. 1298, 1308 (S.D.N.Y. 1979)(citations omitted), *aff'd in part, rev'd in part*, 691 F.2d 1054 (2d Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983), *on remand*, 735 F.2d 23 (2d Cir. 1984).

[34]475 F. Supp. at 1308.

[35]*Id.*

[36]*Id.*

[37]691 F.2d at 1063.

[38]435 U.S. 702 (1978).

[39]*Id.* at 718 n.33 (citation omitted).

by which they could have demanded that any single individual participate in a plan. Neither of the *Spirt* decisions explains how the mandatory participation requirement imposed by the university could possibly affect TIAA-CREF liability.[40]

Similarly, the court of appeals failed to explain the nature or importance of the university's sharing in the "administrative responsibilities" that arose from the participation of university employees in the TIAA-CREF plans. The only employer "responsibilities" mentioned in the cases are deducting pay from the employees and sending it, along with employer contributions, to the insurers.[41]

The assertion that TIAA and CREF were "closely intertwined" with Long Island University and other colleges and universities is especially troubling when considered in conjunction with the reference to the Supreme Court's statement in *Manhart* regarding the futility of delegating responsibilities to a corporate shell to avoid Title VII liability.[42] The fact that TIAA and CREF serve over 2,800 colleges and universities makes it clear that TIAA and CREF are anything but "corporate shells."[43] The additional statement that TIAA and CREF exist "solely for the purpose of enabling universities to delegate" responsibilities for benefits adds nothing but confusion; although the statement may be true its significance is never revealed.

The paucity of analysis and explanation in *Spirt* is characteristic of the opinions which impose Title VII liability on third party insurers. A study of the opinions leaves it unclear whether the *Spirt* courts were attempting to characterize TIAA and CREF as "employers" or "agents" of Long Island University. The conclusory nature of the opinions and their lack of clarity is revealed by a careful analysis of the concepts of "agent" and "employer," because a third party insurer fits into neither catagory.

C. *Agency*

Exactly who may be considered an "agent" under Title VII is not clear. The legislative history of the Act does not reveal the reasons for including the term, and the term is not specifically defined in the Act.[44] In addressing the issue of whether or not an insurer may be an "agent" for purposes of Title VII, the courts have suggested two basic approaches: the application of traditional agency principles[45] or a "piercing the

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[40]*E.g.*, 691 F.2d at 1063 (fact that participation was mandatory was described, without explanation, as significant). *Cf. Norris*, 103 S. Ct. at 3497 n.10 ("It is irrelevant that female employees in *Manhart* were required to participate in the pension plan, whereas participation in the [plan at issue in *Norris*] is voluntary.").

[41]691 F.2d at 1057.

[42]*See supra* text accompanying note 39.

[43]*See supra* text accompanying note 39. *See also infra* text accompanying notes 68-69.

[44]*See supra* notes 22-23.

[45]*See Norris*, 103 S. Ct. 3492; *Peters*, 691 F.2d 235.

corporate veil" analysis where one corporation is deemed an "agent," "instrumentality," or "sham" of the other.[46] Although both approaches were intimated by the Second Circuit in *Spirt*,[47] neither was specifically followed. The Sixth Circuit, however, adopted both approaches to some extent in *Peters v. Wayne State University*[48] and *EEOC v. Wooster Brush Employees Relief Association*.[49]

The following discussion will examine the agency analyses in three contexts. The first, the *Spirt-Peters* situation, involves a nonprofit insurer that contracts directly with the insured with the approval of the employer. The employer in this instance assists both the insurer and the insured by deducting proper amounts from the salary of the insured and making additional contributions. The insurer in this context deals with numerous employees and employers.[50] The second situation, denominated the *Wooster Brush* context, again involves a nonprofit insurer contracting directly with the employee. The insurer receives major contributions from the employer on behalf of the employees and deals solely with one employer and its employees.[51] The third situation, called the *Commercial* context, could apply given a commercial group insurer. This context involves a major for-profit corporate insurer who contracts directly with the employer. Generally, a master contract is negotiated between the insurer and the employer-policyholder, and individual certificates, outlining the coverage provided by the master contract, are issued to the employees. The employees may or may not make individual contributions depending upon the type of plan requested by the employer.[52]

1. Traditional Agency Principles.—The most obvious approach to a determination of agency status for purposes of Title VII, given the lack of any specific definition in the Act, is the application of traditional agency principles. One of the basic canons of statutory construction is that when a common law word has been used, absent a different definition expressed or implied, the common law meaning should be applied.[53] The traditional agency relationship includes four elements: (1) a consensual relationship between two parties; (2) one party, the agent, holds a fiduciary position with regard to the other party, the principal; (3) the continuous right of the principal to control the conduct of the agent; and (4) the power of the agent to affect the legal relations of the

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[46]*E.g.*, *Peters*, 691 F.2d 235.

[47]691 F.2d 1054.

[48]691 F.2d 235 (6th Cir. 1982), *vacated*, 103 S. Ct. 3566 (1983).

[49]727 F.2d 566 (6th Cir. 1984).

[50]The *Spirt-Peters* context is based on the facts in *Spirt*, 691 F.2d 1054, and *Peters*, 691 F.2d 235. The situation is unique because the companies sued, TIAA and CREF, are nonprofit corporations and deal solely with colleges and universities and their employees.

[51]The *Wooster Brush* situation is based on the facts in *Wooster Brush*, 727 F.2d 566. The *Wooster Brush* case involved a small nonprofit insurer that dealt only with Wooster Brush Company employees. The Wooster Brush Company voluntarily contributed to the insurer 50% of its operating fund.

[52]*See* R. KEETON, INSURANCE LAW § 2.8(c), at 66-67 (1971).

[53]*E.g.*, Owens v. Rush, 24 F.E.P. 1543, 1561 (D.C. Kan. 1971).

principal.[54]

The first of these elements, a consensual relationship, presents no obstacle to a finding of agency in either the *Spirt-Peters*, *Wooster Brush* or *Commercial* contexts. In the *Spirt-Peters* and *Wooster Brush* situations, the approval and contributions by the employer clearly indicate consent to the relationship. In the *Commercial* context, the contract between the insurer and the employer establishes the requisite consent.

The second element, a fiduciary relationship between the employer and the insurer, is much more difficult to establish. A fiduciary relationship implies a confidential relationship where the agent has a duty to perform his responsibilities faithfully and loyally for the benefit of the principal.[55] In all three situations considered here, as in any insurance case, the insurer has a fiduciary duty to the insured employees. This duty arises from the unequal bargaining positions of the parties and the reliance placed by the individual insured on the insurer.[56] In the *Spirt-Peters* situation, these considerations do not arise in the insurer-employer relationship. The college or university that makes an agreement to contribute to the employees' retirement fund is not in the disadvantageous position of an individual buying insurance or annuity coverage. Universities, as with other businesses, are generally experienced in business and have a higher degree of bargaining power than an individual. Nor is reliance placed upon the insurer to protect the interests of the employer; as mentioned above, the interests to be protected are those of the employee.

Similarly, in the *Wooster Brush* context, the insurer's fiduciary duty is to the employee. The contributions made by the employer are voluntary and the resulting benefit to be protected is that of the employee. The employer has no special interest to be protected and deals at arm's length with the insurer. The insurer's fiduciary duty runs only to the employee with whom the insurer has contracted.

In the *Commercial* context, the considerations are the same. The employer deals with the insurer at arm's length,[57] and only the employee has special interests to be protected. The employer is in no disadvantaged position requiring more than the fulfillment of the insurer's promise to provide benefits established by the initial contract. No special loyalty is established; the insurer does not act solely in the employer's interest. Therefore, in the *Commercial* context, as well as in the *Spirt-Peters* and *Wooster Brush* situations, the fiduciary element is absent.

Similarly lacking in all three insurer-employer relationships is the third element, the power of the "agent" to affect the legal relations of

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[54]*See* W. SEAVY, AGENCY § 3 at 3-6 (1964); RESTATEMENT (SECOND) OF AGENCY, §§ 1, 14 (1958).

[55]*See* W. SEAVY, AGENCY § 3, *supra* note 54, at 3-6.

[56]*See, e.g.*, Henning v. Metropolitan Life Ins. Co., 546 F. Supp. 442, 446-47 (M.D. Pa. 1982); Brezan v. Prudential Life Ins. Co. of Am., 507 F. Supp. 962, 966 (E.D. Pa. 1981).

[57]Henning v. Metropolitan Life Ins. Co., 546 F. Supp. 442, 446-47 (M.D. Pa. 1982).

the "principal." The insurer is in no position to affect unilaterally the legal obligations of the employer in relation to third parties. Illustrative of this fact is the result of an insurer's failure to pay benefits owed an employee under a given plan. If the insurer were merely the agent of the employer, the agent's failure to pay prescribed benefits would result in the principal-employer being directly liable to the employee for the failure to pay.[58] This, however, is not the case. In the insurance context, the employee looks to the insurer for payment of benefits and seeks to hold the insurer accountable for its failure to conform with the terms of the insurance contract.[59]

The final element, the principal's continuous right to control the conduct of the agent, is also missing in the three situations under discussion here. The control element requires that the principal have a continuing right to control the activities and operations of the agent with regard to the duties for which the agent is responsible.[60] In the *Spirt-Peters*, *Wooster Brush*, and *Commercial* contexts, once the employer chooses to deal with the insurer, the employer has no control over the insurer's operations.[61] The insurers are completely independent entities,[62] and the administrative policies of the insurers are not within the employers' control.[63] Indeed, the decisions regarding which plans are available and what mortality tables are used ultimately are decisions made by the insurer;[64] they are not subject to modification in any way without a renegotiation of the contract that binds the parties in the first instance.[65]

Close analysis thus reveals that only one of the four necessary elements of agency, a consensual relationship, is present in the *Spirt-Peters*, *Wooster Brush*, and *Commercial* contexts. Because all four elements are not found, insurers cannot be brought within the definition of "agent" if the term is given its traditional common law definition.[66]

The courts have not, however, strictly confined their analyses to the common law requirements for agency. In light of the broad remedial

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[58]*See generally* W. SEAVY, AGENCY § 56, *supra* note 54, at 101-04.

[59]*See, e.g.*, Henning v. Metropolitan Life Ins. Co., 546 F. Supp. 442 (M.D. Pa. 1982)(employee under group policy sues insurer to enjoin offset of policy benefits); Equitable Life Ins. Soc'y of the United States v. Kelleman, 224 Ind. 526, 69 N.E.2d 244 (1946) (group insurer sued for recovery of death benefits).

[60]*E.g.*, NLRB v. Local No. 64, Falls Cities Dist. Council of Carpenters, 497 F.2d 1335, 1336 (6th Cir. 1974).

[61]*E.g.*, *Peters*, 691 F.2d at 238.

[62]*E.g.*, *id.*; *Wooster Brush*, 727 F.2d at 572-73.

[63]*E.g.*, *Peters*, 691 F.2d at 238; *Wooster Brush*, 727 F.2d at 572-73.

[64]*E.g.*, *Peters*, 691 F.2d at 238.

[65]*See* 19 COUCH ON INSURANCE 2D § 82:31, at 759-60, § 82:80-81, at 827-31 (rev. ed. 1983).

[66]*See, e.g.*, NLRB v. Local No. 64, Falls Cities Dist. Council of Carpenters, 497 F.2d 1335, 1336 (6th Cir. 1974)(Control is a fundamental element of agency.). *See also* Owens v. Rush, 24 F.E.P. 1543, 1562 (D.C. Kan. 1971) ("Generally a Title VII 'agent' is an intermediate in hierarchy, a supervisory employee with the power to affect plaintiff's employment. . . .The sweep of Title VII's remedial provisions is broad, but not all-inclusive.").

purposes of Title VII,[67] a more relaxed requirement has been suggested in cases where two corporations are involved.

2. The "Sham" or "Instrumentality" Construction.—Instead of requiring the presence of all four of the factors required to establish a traditional agency relationship, the more liberal approach focuses on the single element of control that is primarily addressed when courts "pierce the corporate veil." Under this analysis, if the corporation sought to be charged as an agent can be characterized as a "sham," "shell," or "instrumentality" of the direct employer, liability under Title VII's "agent" requirement may be invoked. This analysis was specifically suggested by the Supreme Court in *Manhart*,[68] where the Court stated that the employer could not avoid liability by delegating its discriminatory program to a corporate shell.[69] This approach was at least mentioned in the *Spirt*, *Peters*, and *Wooster Brush* cases.[70]

To find that one corporation is an agent or instrumentality of another, there are generally five considerations: (1) that records, accounts, capital, employees, or transactions of the two companies are intermingled; (2) that the corporate formalities of the two entities are not observed; (3) that each corporation is not adequately financed; (4) that the two corporations are not held out as distinct entities; and (5) that the policies of the "agent" corporation are directed primarily to the interest of the "principal" corporation.[71]

In the *Wooster Brush* context, none of these criteria is met. Indeed, the court in the *Wooster Brush* case found specifically that the Employees Relief Association was not a "sham."[72] Although the Wooster Brush Company donated money to the Association, there was no indication that funds were intermingled.[73] Records were kept distinct and employees were not freely exchanged.[74] There was no evidence of inadequate financing or a failure to keep the two entities formally distinct.[75] The employees of the company were fully aware of the separation of the two corporations.[76] Finally, the policies of the Employees Relief Association were established by the association's board and directed to the interests of the employees, not the employer.[77]

The insurers in the *Spirt-Peters* context also do not qualify as instrumentalities of the employer-universities. TIAA and CREF are in-

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[67]*See supra* text accompanying notes 20-24.

[68]435 U.S. at 718 n.33.

[69]*Id. See supra* text accompanying note 39.

[70]*Wooster Brush*, 727 F.2d at 573; *Peters*, 691 F.2d at 238; *Spirt*, 691 F.2d at 1063.

[71]H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 148, at 355-57 (3d ed. 1983).

[72]727 F.2d at 573.

[73]The Wooster Brush Company did contribute substantially to the association fund, but the moneys were apparently not intermingled. *See supra* note 51.

[74]*See Wooster Brush*, 727 F.2d at 572.

[75]*Id.* at 571-73.

[76]*Id.* at 573.

[77]*Id.* at 569.

dependent corporations providing insurance services to over 2,800 distinct and unrelated colleges and universities nationwide.[78] This fact in itself makes it evident that no one of these 2,800 institutions has the necessary control over TIAA-CREF or is intermingled with TIAA-CREF in such a way that either of the insurers could be characterized as an instrumentality or sham of an individual university.[79]

In the *Commercial* context, the necessary corporate distinctions and independence are present by definition. A corporate commercial insurer operates as a valid, distinct corporation dealing with numerous independent employers. It maintains its own employees, dictates its own policies for its own benefit, and is required by legislation to maintain sufficient financial reserves.[80] In none of the three contexts discussed here, therefore, are the factors present to bring the insurers within the more liberal interpretation of "agent."

The conclusion is inescapable that an independent third party insurer cannot, in any of the contexts discussed here, be brought within the purview of Title VII's prohibition of discrimination by "any agent" of an employer covered by the Act. None of the recognized analyses of the agency relationship results in a finding that the insurer is an "agent," and no new approach has been suggested. If agency were in fact the underlying rationale of the decisions which have imposed liability on third party insurers, the foregoing analysis demonstrates that these opinions are incorrect. Moreover, for courts to broaden the concept of agency beyond any heretofore recognized parameters of the term is a functional amendment to Title VII that should not be attempted without legislative guidance.

D. The Insurer as "Employer"

The remaining possibility for imposing direct liability on the third party insurer under Title VII is to find that the insurer is an "employer" within the meaning of the term as used in the Act. Of course, the insurers are not the insureds' employers in the commonly understood sense of the term. In the *Spirt-Peters* context, the universities are the employers. In the *Wooster Brush* case, the Wooster Brush Company is the employer, and in the *Commercial* context, the employer is the holder of the master contract. As was the case with the agency question, even when more liberal definitions are attributed to the term "employer," reasoned analysis of the question results in the conclusion that liability should not be found.

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[78]*Spirt*, 691 F.2d at 1057.

[79]That TIAA and CREF were "instrumentalities" of Long Island University may have been what the *Spirt* court meant in the statement that TIAA and CREF are "so closely intertwined" with the university that they must be deemed "employers." *Id.* at 1063.

[80]*E.g.*, IND. CODE § 27-1-6-14 to -15 (1982).

1. The Joint Employer Analysis.—The one approach that has been suggested for finding "employer" liability under Title VII when the party charged is not the plaintiffs' actual employer is the "joint employer" analysis set forth in *EEOC v. Wooster Brush Employees Relief Association*.[81] In *Wooster Brush*, as in *Peters*, the Sixth Circuit found that the insurer was not an "employer" under Title VII. The joint employer analysis used in *Wooster Brush* was adopted from *Baker v. Stuart Broadcasting Company*.[82] The *Baker* court set forth four criteria for determining whether two entities constitute a single employer for purposes of Title VII: (1) interrelation of operations; (2) common management; (3) centralized control of labor relations; and (4) common ownership and financial control.[83]

The *Baker* analysis, adopted in light of the broad interpretations demanded by Title VII,[84] is the most liberal of any approach discussed in this Note. While focusing on the interrelation of two companies, liability does not depend upon whether one of the companies is an "agent" or "instrumentality" of the other.[85] Hence, less domination or control is necessary. Although these criteria involve fact-sensitive considerations, the applicability of which will depend largely on the nature of the insurer's organization, a sufficient number of these elements are not found in any of the three contexts considered here to establish insurer liability as an "employer."

The *Wooster Brush* court found that the first of the *Baker* criteria, interrelationship of operations, was met in the case of the Employees Relief Association for a variety of reasons. Membership in the association was conditioned only upon a physical examination, employment with the Wooster Brush Company, an agreement to join, and the paying of

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[81]727 F.2d at 571. *Wooster Brush* differed from *Spirt* and *Peters* in that the discrimination alleged was founded on the failure of the insurance plan to provide pregnancy-related disability benefits while providing benefits for disabilities not related to pregnancy. Discrimination regarding pregnancy is included in 42 U.S.C. § 2000e-2(a) as "sex-discrimination" by virtue of the the definition given the phrase "on the basis of sex" in 42 U.S.C. § 2000e(k):

> The terms "because of sex" or "on the basis of sex" include, but are not limited to, because of or on the basis of pregnancy, childbirth, or related medical conditions; and women affected by pregnancy, childbirth, or related medical conditions shall be treated the same for all employment-related purposes, including receipt of benefits under fringe benefit programs, as other persons not so affected but similar in their ability or inability to work. . . .

[82]560 F.2d 389 (8th Cir. 1977). *Baker* involved a sex discrimination suit under Title VII filed by Baker against Stuart Broadcasting and Grand Island Broadcasting, Ltd. The court used the test to decide whether or not the two defendant corporations could be combined in order to fulfill the requirement of section 2000e(b) that the "employer" have 15 or more employees.

[83]*Baker*, 560 F.2d at 392.

[84]*Id.* ("In view of the liberal treatment accorded to Title VII, we conclude that these factors should be applied in the determination of 'employer' under 42 U.S.C. § 2000e(b).").

[85]*Cf. infra* text accompanying notes 100-02.

dues.[86] The association depended wholly upon company employees who volunteered to operate the association.[87] Those employees who ran the association did so on company time and used company space and equipment.[88] The association's board of directors was also elected using company facilities.[89]

Such a conclusion regarding the first criterion, however, would be difficult to reach in the case of a university in the *Spirt-Peters* context. Whereas the association in *Wooster Brush* dealt only with the Wooster Brush Company and its employees, as indicated earlier, TIAA and CREF deal with over 2,800 colleges and universities and do not depend on any one of those institutions or their employees for the operation of the TIAA-CREF corporations.[90] TIAA and CREF's operations thus function independently of any one college or university,[91] and interrelation of operations is therefore not present.

Similarly, the first criterion would necessarily be absent in the case of a commercial group insurer. As with TIAA-CREF, such insurers are independent entities whose operations are in no way interrelated with any particular employer to whom insurance services are provided. For-profit corporations of this type have their own boards of directors, officers, and employees, and depend on their clients for no more than the business they generate.[92]

The second criterion, common management, was found to be absent by the court of appeals in the *Wooster Brush* case. The district court in *Wooster Brush* found that there was common management of the company and the association because the president of the company was also a managing member of the association.[93] This conclusion was rejected by the court of appeals because the president's rise to positions in both organizations was purely fortuitous.[94]

Common management is likewise absent in the relationship between TIAA-CREF and any one college or university. TIAA and CREF are run by boards and employees having no special ties to any of the hundreds of colleges and universities for which services are provided.[95] Such is also the case with commercial insurers. Commercial insurance companies are managed as entities distinct from the companies and organizations with which they do

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[86]727 F.2d at 572.

[87]*Id.*

[88]*Id.*

[89]*Id.*

[90]*Spirt*, 691 F.2d at 1057.

[91]*See id.*

[92]Telephone interview with Jack D. Hunter, Esq., General Counsel, Lincoln National Corporation (Jan. 14, 1985).

[93]*Wooster Brush*, 727 F.2d at 572.

[94]When the association was formed, the president was an ordinary employee at Wooster Brush Company. His rise to presidency in the company had nothing to do with the association. *Id.*

[95]*See Peters*, 691 F.2d at 238.

business.[96]

The third criterion, centralized control of labor relations, was also held to be lacking in *Wooster Brush*. Again overruling the district court's finding, the court of appeals held that the association's dependence upon the company for facilities and volunteers was not sufficient to meet this requirement.[97] The court of appeals found no evidence that the association made any attempt to control labor relationships. This control was vested entirely in the company; the association's sole purpose was to provide insurance.[98] The same is also true in the *Spirt-Peters* and *Commercial* situations. The insurers do no more than provide insurance services upon request. The decision regarding whether insurance will be purchased, what company will provide the coverage, and what types of benefits will be included are all within the ultimate discretion of the employer.[99]

The final criterion, common ownership and financial control, also fails in all three of the situations discussed here. The Sixth Circuit pointed out in *Wooster Brush* that this fourth prong of the *Baker* analysis has been interpreted to require an inquiry into the legitimacy of the two entities in question. If the companies under consideration are distinct legal enitities, if neither is a "sham" or "instrumentality" of the other, then this criterion is not met.[100] The court found that the association was not a "sham," so this fourth part of the test failed.[101] As discussed previously, in none of the present situations is the insurer a "sham."[102]

The Sixth Circuit's characterization of the fourth prong of the test, however, seems to venture beyond the interrelation required by the *Baker* test.[103] Common management or financial control is not alone a sufficient basis for treating a corporation as a "sham"; neither would normally justify piercing the corporate veil.[104] Yet, these considerations may well be sufficient to satisfy the *Baker* test.[105] A less rigorous requirement would also better comport with the liberal interpretations generally given Title VII be-

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[96]*See supra* note 92 and accompanying text.

[97]727 F.2d at 572.

[98]*Id.*

[99]*Peters*, 691 F.2d at 238; *see Norris*, 103 S. Ct. at 3501.

[100]*Wooster Brush*, 727 F.2d at 572-73.

[101]*Id.* at 573.

[102]*See supra* text accompanying notes 71-80.

[103]It is not clear that a finding of "instrumentality" or "sham" is necessary to find "common managerial control." In the *Baker* case from which the test was adopted, the court mentioned only that the two corporations had common directors and one provided services to the other. These factors alone are generally not considered sufficient to disregard the separate identity of one of the corporations. *See* H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 148, *supra* note 71, at 355. *See also* Linsky v. Heidelberg E., Inc., 470 F. Supp. 1181, 1184 (E.D.N.Y. 1979) (characterizing the "joint employer" and "agent" or "instrumentality" tests as two distinct tests).

[104]*See supra* note 103.

[105]*Id.*

cause of the remedial nature and important social goals of the Act.[106]

Even if this more liberal view is taken, however, the fourth criterion is not met in any of the present contexts. As was the case in the agency analysis above, the requisite control element is lacking in all three cases. Different persons control the respective organizations.[107] In the *Wooster Brush* context, the company did contribute substantially to the association's fund, but this did not give the company the "control" over operations which is suggested by the *Baker* test.[108] In the *Spirt-Peters* and *Commercial* situations, financial independence is evidenced by the fact that the insurers deal with numerous independent clients.[109] Under the joint employer test, therefore, none of the insurers considered here would be an "employer."

2. "Significantly Affects": The Spirt *Definition.*— One final definition of "employer," recognized in *Spirt*, defines an employer as "any party who significantly affects access of any individual to employment opportunities."[110] Although the *Spirt* court apparently thought that this definition would bring an insurer within the purview of Title VII, a closer analysis reveals that an insurer is not an "employer" even when the term is given this very broad definition.

First, the phrase "significantly affects" logically requires some control over the thing affected. In the present context, the insurer must control the decision as to whether or not the employee will receive a particular benefit as a result of his employment with a particular company. To affect something requires the ability to change it in some respect; unless the insurer has the power to change the benefits given to the employee, it cannot be said to "significantly affect" his access to benefits.

It is clear, however, that the insurers in neither the *Spirt-Peters*, *Wooster Brush*, nor *Commercial* situations have this type of control over the provision of benefits as a result of the employment relationship. In all three cases, it is in the ultimate discretion of the employer which company he will choose to provide insurance coverage to his employees, and therefore it is the employer's decision regarding what benefits will be provided his employees at reduced or no cost.[111]

The only way that the insurer can be characterized as having "control" over what benefits are provided is to find "control" in the fact that the insurer decides what benefit plans it will offer to the employers.

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[106] *See Baker*, 560 F.2d at 392.

[107] *See supra* text accompanying notes 93-96.

[108] *Wooster Brush*, 727 F.2d at 572.

[109] *See supra* text accompanying notes 78-80.

[110] 691 F.2d at 1063.

[111] *Cf. Norris*, 103 S. Ct. at 3501-02 ("[E]mployers are ultimately responsible for the 'compensation, terms, conditions, [and] privileges of employment' provided to employees . . . . An employer who [cannot find a nondiscriminatory plan] must either supply the fringe benefit himself, without the assistance of any third party, or not provide it at all.").

If liability were based on this type of "control," this characterization would impose an affirmative duty on the insurer to establish benefit plans in strict compliance with Title VII, regardless of whether the insurance company may consider such plans sound, marketable, or profitable. This, however, cannot be the case. Although Title VII's reach is broad, the Act was not intended to dictate affirmatively the business decisions of independent insurance companies regarding what options may be offered on the open market. Aside from the fact that there is no basis in the language of the Act for imposing such a duty on insurance companies, such an "interpretation" of the Act would contradict the statements that the United States Supreme Court has made on the issue. The Court has emphasized repeatedly that Title VII is intended to govern the traditional employer-employee relationship, not that of employees and third parties.[112] Indeed, the Court has stated specifically that Title VII has its limitations and that the Act was not "intended to revolutionize the insurance and pension industries."[113] Imposition of liability and the consequent duty to conform insurance coverage plans to Title VII would require a radical change that the Supreme Court has stated was unintended by the Act.[114]

E. The Policy Argument

The final argument in support of insurer liability, and that most heavily relied upon by the *Spirt* court, is that if the insurer is not held liable, the plaintiffs would have only incomplete remedies. "[E]xempting plans not actually administered by an employer would seriously impair the effectiveness of Title VII . . . ."[115]

The fallacy in this argument is that it confuses the parties with the employment practice. Of course, if neither the employer nor the insurer could be reached under Title VII, the proscribed employment practice would go unremedied. The discrimination inherent in the plan would go unchallenged for lack of parties to be charged. This, however, is not the case. In *Spirt* itself, as well as all of the other cases addressing these issues, the traditional employer has been held liable and a full and effective remedy imposed.[116] It is true that if the insurer is not held

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[112]*Norris*, 103 S. Ct. at 3499; *Manhart*, 435 U.S. at 718 n.33.

[113]*Manhart*, 435 U.S. at 717.

[114]Reorganization of rates, reformation of established actuarial practices, and monumental cost increases are among those changes that would be necessary. *See Norris*, 103 S. Ct. at 3504-06 (Powell, J., dissenting).

[115]*Spirt*, 691 F.2d at 1063.

[116]*E.g.*, *Norris*, 103 S. Ct. 3492; *Spirt*, 691 F.2d 1054; *Peters*, 691 F.2d 235. *See also* Brunetti v. Wal-Mart Stores, 525 F. Supp. 1363 (E.D. Ark. 1981) (reimbursement of medical expenses ordered which would have been covered by employer's group insurance but for the wrongful termination); Gaballah v. Roudebush, 421 F. Supp. 475, 480 (N.D. Ill. 1976) ("If a job-related discrimination based on race, color, religion, sex or national origin is proved, the district court, within its equitable jurisdiction, could order employment, promotion or any other deprived benefit, back pay or lost income, and injunctive relief if necessary."); EEOC v. Kallir, Philips, Ross, Inc., 420 F. Supp. 919, (S.D.N.Y. 1976) (employer ordered to reimburse unlawfully discharged employee for medical expenses incurred after discharge that would have been reimbursable under employer's insurance policy).

liable, the *plan* will not be invalidated. However, insurance was not targeted by Title VII. Rather, Title VII was designed to prevent discriminatory employment practices,[117] and such practices are effectively redressed by holding the employer alone liable for the employment violations.[118]

The adequacy of employer liability was emphasized repeatedly by the Supreme Court in *Arizona Governing Committee v. Norris*,[119] where the district court granted full relief to the plaintiffs in a suit where the insurer was not joined. The Court found insurer liability unnecessary, stating that "employers are ultimately responsible for the 'compensation . . .' provided to employees . . . ."[120] "An employer who confronts such a situation [where it cannot find a nondiscriminatory plan] must either supply the fringe benefit himself, without the assistance of any third party, or not provide it at all."[121]

Those courts that have extended the reach of Title VII to impose liability on third party insurers undoubtedly sought to further the important policy of equality among this country's workers. The best of intentions, however, does not always produce the best law, and such is the case with the precedent favoring insurer liability. If insurer liability were necessary to carry out congressional and social policy, perhaps a basis for extension of the Act could be found. Third party insurer liability, however, is not only unwarranted by the case law and the language of Title VII, but is unnecessary as well.

III. Immunity Under the McCarran-Ferguson Act

Even if an insurer were brought within the definition of "employer" or "agent" for purposes of Title VII, the question of exemption from application of Title VII by operation of the McCarran-Ferguson Act (MFA)[122] would still arise.

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[117] *See supra* text accompanying notes 20-24.

[118] *See supra* note 116 and accompanying text.

[119] 103 S. Ct. 3492.

[120] *Id.* at 3501.

[121] *Id.* at 3502.

[122] 15 U.S.C. §§ 1011-1015 (1982). The sections under consideration here, §§ 1011-1012(b) state:

§ 1011. Declaration of Policy

> Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

§ 1012. Regulaton by State law; Federal law relating specifically to insurance; applicability of certain federal laws after June 30, 1948

> (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
>
> (b) No Act of Congress shall be construed to invalidate, impair, or

A. Background of the MFA

In 1943, the United States Supreme Court held in *United States v. South-Eastern Underwriters Association*[123] that the business of insurance was "interstate commerce" and therefore subject to federal regulation. In so holding, the Court overruled prior decisions that had consistently held that the business of insurance was primarily a "local activity." As a result of the treatment of insurance as a local activity not subject to federal regulation, the states had taken upon themselves the job of regulating insurance and had developed comprehensive regulation of insurers.[124] The sudden reclassification of insurance as interstate commerce placed in question the validity of the state regulations and created uncertainty throughout the insurance industry.

The reaction in Congress to *South-Eastern Underwriters* was immediate. Motivated by myriad concerns,[125] legislation was introduced into both houses of Congress[126] that would, in effect, overrule the result of *South-Eastern Underwriters* and return the power to regulate the insurance

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> supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided*, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended . . . , shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

[123]322 U.S. 533 (1944). *South-Eastern Underwriters* was the first case in which the United States Supreme Court found that insurance was part of interstate commerce and thus subject to regulation by the Sherman Antitrust Act. The decision overruled such long-standing precedents as New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495, 510 (1913) ("contracts of insurance are not commerce at all, neither state nor interstate"); Hooper v. California, 155 U.S. 648, 655 (1895) ("The business of insurance is not commerce."); Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183 (1869) ("[i]ssuing a policy of insurance is not a transaction of commerce"). For additional cases and analysis of these precedents, see B. GAVIT, THE COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION at 134-39 (1932).

[124]*See* Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 430 (1946); *see also infra* note 125.

[125]Having developed pervasive legislation covering all aspects of the insurance industry, the states were concerned that many of the laws, such as those establishing uniform rates and taxing of out-of-state insurers, would be found unduly burdensome on the flow of commerce and thus invalid. *Cf.* New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495 (insurer's challenge against a Montana tax alleged to constitute a burden on interstate commerce was rejected because insurance was not interstate commerce). In addition to the states' concerns that they would no longer be able to collect substantial revenues provided by insurance taxes, the insurers also found themselves in a difficult position. It was feared that no matter how they acted they would violate some law; if they complied with state rate-fixing regulations, they would vioalte federal antitrust proscriptions, while complying with the federal laws would violate the state regulations. *See* 91 CONG. REC. 478-88 (1945); Note, *McCarron-Ferguson Act Immunity from the Truth in Lending Act and Title VII*, 48 U. CHI. L. REV. 730, 732-36 (1981).

[126]H.R. 1973, 79th Cong., 1st Sess. (1945); S.R. 340, 79th Cong., 1st Sess. (1945).

industry to the states.[127] The final result was the emergence of the MFA. With narrow exceptions,[128] the MFA exempts the "business of insurance" from the effect of federal legislation that would "invalidate, impair, or supersede" state laws unless the federal legislation "specifically relates" to the business of insurance.[129]

B. The Plain Language of the MFA

For the MFA to exempt an insurer from the reach of Title VII and carry out Congress' desire to preserve the states' regulation of the insurance industry, three facts must be established. It must be shown that the insurer's activity in question constitutes the "business of insurance"; that the application would "invalidate, impair, or supersede" a state law; and, that Title VII does not "specifically relate" to the business of insurance.[130]

1. The Business of Insurance.—The exemption of the "business of insurance" does not comprehend all activities in which an insurer may engage.[131] Activities that are not peculiar to the industry, such as the company's relations with its own employees[132] or securities dealings,[133] are still subject to the full regulatory effect of federal legislation.[134] Rather, it is the relationship between the insurer and the insured that was intended as the object of the exemption; Congress was concerned with the contract of insurance itself, the terms, the rates, and other

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[127]*See* H.R. REP. No. 143, 79th Cong., 1st Sess. (1945):

> Inevitable certainties which followed the handing down of the decision in the *South-Eastern Underwriters Association* case, with respect to the constitutionality of State laws, have raised questions in the minds of insurance executives, State insurance officials, and others as to the validity of State tax laws, as well as State regulatory provisions; thus making desirable legislation by the Congress to stabilize the general situation . . . . The committee has therefore given immediate consideration to S. 340, together with a similar measure H.R. 1973, so that the several States may know that the Congress desires to protect the continued regulation and taxation of the business of insurance by the several States, and thus enables insurance companies to comply with State laws. What is more, the Congress proposes by this bill to secure adequate regulation and control of the insurance business.

Id.

[128]15 U.S.C. section 1012(b) provides that the Sherman Act, the Clayton Act, and the Federal Trade Commision Act shall be applicable to the business of insurance in areas which state law has not regulated. 15 U.S.C. section 1014 provides that the National Labor Relations Act, the Fair Labor Standards Act, and the Merchant Marine Act shall be applicable to the business of insurance.

[129]*See supra* note 122.

[130]*Id.*

[131]*E.g.*, SEC v. Nat'l Sec., Inc., 393 U.S. 453 (1968) (holding that an insurer was not exempt from the effect of section 10(b) of the Securities Exchange Act by the McCarran-Ferguson Act (MFA) because regulation of securities is not part of the "business of insurance").

[132]*See supra* note 128.

[133]SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

[134]*Nat'l Sec.*, 393 U.S. at 459-60.

matters previously controlled by the states.[135]

Insurance practices such as the use of sex-segregated mortality tables to determine rates and the exclusion of pregnancy benefits from a particular contract are elements of the rates and terms of insurance contracts and thus fall within the purview of "the business of insurance" of the MFA. *Spirt* and *Peters* involved challenges to the validity of mortality tables and the *Wooster Brush* case involved the exclusion of pregnancy disability benefits from an insurance contract. Because these are elements of the rates and terms of insurance contracts, the "business of insurance" requirement for MFA exclusion is therefore met in all of these cases.[136]

2. Invalidate, Impair, or Supersede.—Imposition of Title VII liability on third party insurers would also meet the second requirement for MFA exemption, that the congressional act "invalidate, impair, or supersede" state law. Application of Title VII would invalidate or impair any state laws that authorize an insurer to use a plan that includes a factor found to be discriminatory under Title VII.[137] In the case of sex-segregated mortality tables, this requirement would be met by state statutes that generally allow gender to be used as a factor in calculating rates.[138] Most state insurance codes have provisions which will allow such classifications,[139] so these provisions would be invalidated or impaired.

Title VII's application to insurers would also "supersede" state laws, because most states have insurance statutes that specifically deal with discrimination in determining rates or benefits.[140] The state statutes prohibit

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[135]*Id.* at 460.

[136]*See, e.g., Spirt*, 691 F.2d at 1064. There is some question regarding CREF's business as "insurance" because CREF deals in variable annuities. *Id.; but cf.* Note, *supra* note 125, at 745-46.

[137]*Norris*, 103 S. Ct. at 3507 n.6 (Powell, J., dissenting).

[138]*See, e.g.*, N.Y. INS. LAW §§ 159(1)(d), 160(c) (McKinney Supp. 1984-85); *see also* IND. CODE § 27-4-1-4(7)(a) (Supp. 1984) ("[I]n determining the class, consideration may be given to the nature of the risk, plan of insurance, the actual or expected expense of conducting the business or any other relevant factor."). There is no question that women do in fact have a longer life expectancy as a class than men; sex is therefore a "relevant factor" in determining the "nature of the risk." *See Norris*, 103 S. Ct. at 3496; *Manhart*, 435 U.S. at 704.

[139]*See Norris*, 103 S. Ct. at 3507 n.6 (Powell, J., dissenting). *See supra* note 138.

[140]*See, e.g.*, N.Y. INS. LAW § 209 (McKinney Supp. 1984-85).

> § 209. Life, accident and health insurance; discrimination and rebating: prohibited inducements and interdependent sales
>
> 1. No life insurance company doing business in this state . . . shall make or permit any unfair discrimination between individuals of the same class and of equal expectation of life, in the amount of payment or return of premiums, or rates charged by it for policies of life insurance or annuity contracts, or in the dividends or other benefits payable thereon, or in any of the terms and conditions thereof . . . .
>
> 2. No insurer doing in this state the business of accident or health insurance . . . shall make or permit any unfair discrimination between individuals of the same class in the amount of premiums, policy fees, or rates charged for any policy

discrimination in all areas that the states have deemed necessary; thus, adding the prohibitions against the use of sex-segregated mortality tables or disability plans without coverage for pregnancy-related disabilities would in effect supersede those laws.[141]

3. Specifically Relates.—The final requirement for MFA exemption, that the federal statute in question not "specifically relate" to the business of insurance, has prompted some disagreement among the courts. Some courts have suggested that Title VII, although it does not specifically mention insurance, may be construed to "specifically relate" to the business of insurance because discrimination is a matter that may arise in the insurance context.[142]

This interpretation, however, leads to an absurd result. If exclusion from the MFA did not require specific statutory reference to insurance, then any law which would naturally function to affect some insurance-related matter could be construed to "specifically relate." The result would be that the MFA would *never* operate. In cases where a statute does not affect insurance, the MFA would not be needed; in cases where a statute would affect insurance, the statute would specifically relate such that the MFA could not operate. A construction that would render the MFA meaningless obviously cannot reflect Congress' intent in passing

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or contract of accident or health insurance, or in the benefits payable thereunder, or in any of the terms or conditions of such contract . . . .

The following are unfair practices under IND. CODE § 27-4-1-4(7)(a)-(b) (Supp. 1984):

(7)(a) Making or permitting any unfair discrimination between individuals of the same class and equal expectation of life in the rates or assessments charged for any contract of life insurance or of life annuity or in the dividends or other benefits payable thereon, or in any other of the terms and conditions of such contract, provided that, in determining the class, consideration may be given to the nature of the risk, plan of insurance, the actual or expected expense of conducting the business or any other relevant factor.

(b) Making or permitting any unfair discrimination between individuals of the same class involving essentially the same hazards in the amount of premium, policy fees, assessments, or rates charged or made for any policy or contract of accident or health insurance or in the benefits payable thereunder, or in any of the terms or conditions of such contract, or in any other manner whatever, provided that, in determining the class, consideration may be given to the nature of the risk, plan of insurance, the actual or expected expense of conducting the business or any other relevant factor.

[141]Some courts have also taken the view that the "invalidate, impair or supersede" requirement is met whenever the state has pervasively regulated the insurance area. *See Spirt*, 475 F. Supp. at 1303 and cases cited therein. This interpretation, however, seems to grant a broader immunity than is required by the language of the MFA; such an interpretation would grant immunity from almost all federal laws and conflict with the evident intentions of the framers. *See generally* Note, *supra* note 125, at 750-54.

[142]*See Spirt*, 691 F.2d at 1065-66; Note, *supra* note 25, at 1292. A rather novel approach was taken by the *Spirt* court. The argument was that New York insurance laws were preempted by the preemption clause of Title VII, section 2000e-7, and thus there was no question of a law being "invalidated, impaired or superseded." 691 F.2d at 1066. The obvious problem with this argument is that if the MFA exemption operates, it would exempt the insurer from section 2000e-7 as well as the other sections of Title VII.

this Act.[143]

C. *Policy Conflicts—The* Norris *Resolution*

Even recognizing that the plain language of the MFA grants insurers immunity from Title VII actions, some courts and commentators have, nevertheless, found liability by restricting the MFA to the antitrust area or finding an "implied repeal" of the MFA by virtue of the policy behind Title VII.[144]

1. Narrow Construction.—The first manner in which the courts have attempted to remove MFA exemption from Title VII cases is through narrow construction of the statute, only allowing its application in the area of antitrust regulation.[145] To arrive at such a narrow construction of the MFA, many courts have given great significance to the fact that the MFA was a direct reaction to *South-Eastern Underwriters.*[146] Because *South-Eastern Underwriters* was a case dealing with the application of federal antitrust laws to insurance rate fixing, the courts reason that antitrust regulation was the primary focus of the MFA. These courts conclude, therefore, that Congress never had any intention that the exemption operate in other areas.[147]

This view is much too simplistic. Both the plain language discussed above and the legislative history of the MFA indicate that this was not Congress' intent. The broad scope of the MFA is expressed repeatedly in statements in the congressional debates such as the declaration that there should be no "doubt as to the right of the states to go ahead and function freely in handling insurance."[148]

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[143]*See Norris*, 103 S. Ct. at 3506-07 nn.5-6. *See also* 91 CONG. REC. 481 (1945) (remarks of Sen. Ferguson):

> Having passed the bill now before the Senate, if Congress should tomorrow pass a law relating to interstate commerce, and should not specifically apply the law to the business of insurance, it would not be an implied repeal of this bill, and this bill would not be affected, because the Congress had not under subdivision (b), said that the new law specifically applied to insurance. I think that makes the bill very clear.

Id.

[144]*See supra* text accompanying notes 20-26 and 142.

[145]*See, e.g., Spirt*, 691 F.2d 1054; Hannahs v. Teachers Retirement Sys., 26 F.E.P. 527 (S.D.N.Y. 1981); Women in City Gov't v. City of New York, 515 F. Supp. 295 (S.D.N.Y. 1981).

[146]*E.g., Spirt*, 691 F.2d at 1065:

> We find . . . that Congress, in enacting a statute primarily intended to deal with the conflict between state regulation of insurers and the federal antitrust laws, had no intention of declaring that subsequently enacted civil rights legislation would be inapplicable to any and all of the activities of an insurance company that can be classified as "the business of insurance."

See also Women in City Gov't, 515 F. Supp. at 303-04.

[147]*See supra* note 146.

[148]91 CONG. REC. 483 (1945) (remarks of Sen. Radcliff). *See also id.* (remarks of Sen. O'Mahoney) (Section 112(b) is "a sort of catch-all provision to take into consideration other acts of Congress which might affect the insurance industry, but of which we do not have knowledge at the time.").

Also indicative of the MFA's broad scope is the evolution of the statute itself. The MFA as first introduced,[149] did deal solely with the area of antitrust by exempting the insurance industry only from the reach of the Sherman Act[150] and the Clayton Act.[151] This initial version of the bill, however, was rejected in favor of the much broader version now in effect. As Justice Powell stated in *Norris*, although Congress was concerned with reconciling antitrust laws with insurance regulations, Congress "also recognized that the decision in *South-Eastern Underwriters Association* had raised questions as to the general validity of state laws governing the business of insurance. . . . Congress thus enacted broad legislation [to protect state regulation from future federal interference]."[152]

The conclusion that the MFA exemption should apply in the context of Title VII is also supported by *Norris*, in which the MFA exemption defense was rejected. The reason given for the rejection of the defense in *Norris* was that the defendant, the plaintiffs' employer in the traditional sense, was not itself engaged in the business of insurance.[153] It would follow from this reasoning that if the defendant were engaged in the business of insurance, as are the insurance and annuity companies considered in this Note, the MFA defense would succeed.

It is thus apparent that rather than suggesting a narrow interpretation, the historical and legislative records, as well as the *Norris* opinion, indicate that the MFA should be broadly construed to effect Congress' declared intention that "the continued regulation . . . by the several States of the business of insurance is in the public interest . . . ."[154]

2. Policy.— The final basis for a rejection of insurer MFA immunity in the context of Title VII has been an alleged conflict between the MFA exemption and the strong policy behind Title VII discussed above.[155] As explained earlier, the conflict has been resolved by the Supreme Court's decision in *Norris*. Complete relief may be granted by imposing liability solely on the plaintiff's actual employer. Because there can be redress for employment discrimination under Title VII without involving

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[149]H.R. 3270 and S. 1360 provided:

> That nothing contained in the Act of July 2, 1890, as amended, known as the Sherman Act, shall be construed to apply to the business of insurance or to acts in the conduct of that business or in any wise to impair the regulation of that business by the several states.

S. REP. No. 1112, pt.2, 78th Cong. 2d Sess. 1-2 (1944).

[150]15 U.S.C. §§ 1-7 (1976).

[151]*Id.* §§ 12-27, 44.

[152]103 S. Ct. at 3507 n.5.

[153]*Id.* at 3500 n.17 ("[T]he plaintiffs in this case have not challenged the conduct of the business of insurance. No insurance company has been joined as a defendant, and our judgment will in no way preclude any insurance company from offering annuity benefits that are calculated on the basis of sex-segregated actuarial tables.").

[154]15 U.S.C. § 1011; *see also supra* notes 122, 143, 148.

[155]*See supra* text accompanying notes 20-25; *see also Spirt*, 691 F.2d at 1063-66; Note, *supra* note 25, at 1292-99; Note, *supra* note 125, at 754-57.

independent third party insurers, exempting insurers from liability presents no barrier to fulfillment of Title VII's policy of employment equality.

The fact that MFA exemption presents no obstacle to the fulfillment of the goals of Title VII is not, however, the only reason for allowing insurers to use the defense. It has apparently been overlooked that there are strong practical considerations favoring the view that while employers should be forbidden to use discriminatory programs, imposing Title VII judgments directly on the insurance industry may well prove to be counterproductive.

First, any spreading of liability necessarily carries with it a corresponding reduction in the employer's incentive to avoid discriminatory practices.[156] The major incentive for compliance with any law of this kind is the financial burden the employer will bear as the result of his failure to conform to the requirements of Title VII. Thus, if the possible financial burden is reduced by spreading liability to the insurer, employer incentive to comply with Title VII will be lessened.

Second, and most importantly, a judgment by the courts that present insurance practices are undesirable runs the risk of being patently wrong. The courts simply do not have the resources and investigative capabilities to evaluate properly the effects of such a decision on the insurance industry and the public as a whole. Only Congress is in a position to make such a judgment. Moreover, exempting insurers from liability will allow market forces to find the best possible system of insuring large groups. If "nondiscriminatory" programs are cost efficient, the profit motive will cause insurers to modify their plans to make them marketable to the employers. On the other hand, if such modifications are untenable, insurance can be provided efficiently according to recognized actuarial practices; employers may simply follow the *Manhart* Court's suggestion and set aside equal sums for each employee to purchase his or her own cost efficient coverage on the open market.[157]

IV. Conclusion

That Congress did not intend third party insurers to be covered under Title VII is evident in the fact that insurers do not fall within the definition of "employer" or "agent" as used in the Act. Moreover, Congress exempted insurers from the application of Title VII through

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[156]*Cf.* EEOC v. Ferris State College, 493 F. Supp. 707, 716 (W.D. Mich. 1980). The court, in denying the employer a right of contribution from a union for a violation of the Equal Pay Act, stated that such a right

> would simply entitle employers to pass off onto third parties their own liability for violations of the Equal Pay Act. Under a contrary holding, employers could discriminate with impunity, fully aware that the total cost of their unlawful behavior would not be borne by them alone. Indeed, . . . if employers are aware that they alone will bear the economic consequences of Equal Pay Act violations, a greater incentive would exist for resisting coercive pressures placed on them by unconscionable unions.

[157]435 U.S. at 717-18.

the McCarran-Ferguson Act. In spite of the law, however, there remains a split of authority regarding insurer liability.

This split in the decisions results, therefore, not from any basic ambiguities in the law, but rather from different perceptions of the judicial function. Those courts imposing liability have done so to reach what they envision as the most desirable result; the courts rejecting liability have based their decisions on the letter of the law.

American law is replete with instances of courts ignoring the letter of the law to reach desired results, and in some cases such an approach may be necessary to further the cause of justice. Such is not the case, however, with insurer liability under Title VII. The courts are not in a practical position to evaluate the ramifications of extending liability to such a mammoth enterprise as the insurance industry. Indeed, there are strong indications that extension of liability could work, ultimately, to the detriment of those individuals whom Title VII was established to protect.

In any case, Congress has thus far made the judgment that insurers should not incur liability under Title VII, and the courts should respect that judgment. The legislature is the only branch of the government with the resources to evaluate properly what laws will best effect social equality in the most practical manner. If liability is to be extended under Title VII, it is the duty of the courts to await the congressional mandate that would come from an amendment of the laws now in effect.

Douglas W. Holly

Work Product Discovery in Insurance Litigation

I. Introduction

One of the major functions of an insurance company is to investigate and pay legitimate claims, as well as to defend against illegitimate claims.[1] Because of the nature of the insurance business, an insurance company must thoroughly examine the facts surrounding a claim. The task of investigation is usually performed by agents or employees who summarize the information for superiors who ultimately decide what should be the appropriate action regarding the claim.[2]

If the insurer refuses to pay or to settle a valid claim or decides not to defend or indemnify its insured, the insured may bring an action against the company for a bad faith breach of the insurance contract.[3] To prove the bad faith allegations, the plaintiff will serve the insurance company with a request for production pursuant to the appropriate statutory provision.[4] Generally, the production request seeks discovery of all the materials prepared or obtained by the insurer for the purpose of making its decision concerning the insured's claim.[5] In response, the insurance company often objects to production of the materials, claiming that the items were prepared in anticipation of litigation and, therefore, are entitled to limited immunity from discovery.[6]

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[1]Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co., 61 F.R.D. 115, 118 (N.D. Ga. 1972); Ainsworth v. Union Free School Dist. No. 2, Queensbury, 38 A.D.2d 770, 327 N.Y.S.2d 873 (1972).

[2]Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. 367 (N.D. Ill. 1972). As stated by the court, appropriate action may include resisting the claim, simply reimbursing the insured, or reimbursing the insured and seeking subrogation of the insured's claim against a third party. *Id.* at 373.

[3]For a discussion of the insurer's liability and the damages which an insured may recover, see Note, *The Tort of Bad Faith: A Perspective Look at the Insurer's Expanding Liability*, 8 Cum. L. Rev. 241 (1977); Note, *Good Faith and Fair Dealing in Insurance Contracts*: Gruenberg v. Aetna Insurance Co., 25 Hastings L.J. 699 (1974).

[4]Fed. R. Civ. P. 34(a). This rule provides in part:

> Any party may serve on any other party a request (1) to produce and permit the party making the request, or someone acting on his behalf, to inspect and copy, any designated documents (including writings, drawings, graphs, charts, photographs, phono-records, and other data compilations from which information can be obtained, translated, if necessary, by the respondent through detection devices into reasonably usable form), or to inspect and copy, test, or sample any tangible things which constitute or contain matters within the scope of Rule 26(b) and which are in the possession, custody or control of the party upon whom the request is served . . . .

Id. See Fed. R. Civ. P. 37(a). This rule states, "A party, upon reasonable notice to other parties and all persons affected thereby, may apply for an order compelling discovery . . . ." *Id. See also* Ind. R. Tr. P. 34, 37 (containing equivalent provisions).

[5]For an example of the materials typically sought, see Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 330-31 n.3, 670 P.2d 725, 728-30 n.3 (1983) (en banc).

[6]The "limited immunity" requires the requesting party to show at least a substantial need for the items, with resulting undue hardship if the substantial equivalent must be obtained elsewhere.

The rules of civil procedure concerning discovery serve as the foundation for determining what materials, if any, are available to the requesting party. Under Federal Rule of Civil Procedure 26(b)(3), a party has limited immunity from discovery of documents and other tangible items that were prepared in anticipation of litigation by or for a party or his representative.[7] The limited immunity provided by federal rule 26(b)(3) is commonly referred to as the work product doctrine.

This Note will examine the policies behind the work product doctrine and the factors used in analyzing whether or not requested materials were prepared in anticipation of litigation. Next, the problems which currently face insurers and claimants and the various approaches to the application of federal rule 26(b)(3) to insurance litigation will be discussed. This Note will demonstrate why a balanced approach is the better view for the fair and consistent resolution of such discovery disputes.

II. Policies and Factors for Applying Federal Rule of Civil Procedure 26(b)(3)

In the landmark decision of *Hickman v. Taylor*,[8] the United States Supreme Court set forth certain policy limitations on the scope of discovery when requested materials have been prepared by an attorney with an eye toward litigation. The Court noted that although the discovery rules should be given broad and liberal interpretation, the just resolution of disputes requires that courts restrain certain inquiries into an attorney's work product.[9]

The Court in *Hickman* outlined several policies underlying the work product doctrine. First, attorneys and parties should be encouraged to keep written records.[10] If an attorney anticipates discovery requests, fear of the potential production of all written records concerning a particular

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[7]Fed. R. Civ. P. 26(b)(3). This rule provides in part:

> Subject to the provisions of subdivision (b)(4) of this rule, a party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including his attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

Id. See also Ind. R. Tr. P. 26(B)(3)(containing equivalent provisions).

[8]329 U.S. 495 (1947).

[9]*Id.* at 498-99.

[10]*Id.* at 511.

client's case may deter him from keeping proper written records.[11] Second, liberal discovery of an attorney's work would tend to diminish the attorney's efficiency, as he would begin to rely more upon his memory for the facts and ideas pertaining to his client's case.[12] Another reason for limiting discovery pertains to the demoralizing effect liberal discovery would have upon the legal profession.[13] The Court noted that liberal discovery of an attorney's work might lead to "unfairness" and "sharp practices."[14] These terms describe actions such as the attempt by the requesting party to take advantage of another's work or the preparation of misleading materials for production to the opposition upon a discovery request.[15] The Court's final policy behind the work product doctrine was to ensure that the interests of clients and the cause of justice were adequately served.[16] As stated by Justice Murphy, "[T]he general policy against invading the privacy of an attorney's course of preparation is so well recognized and so essential to an orderly working of our system of legal procedure that a burden rests on the one who would invade that privacy to establish adequate reasons . . . ."[17]

Federal Rule of Civil Procedure 26(b)(3), which was enacted in 1938, codifies the policies expressed in the *Hickman* decision.[18] Notwithstanding the obvious importance of the policies and their codification, many courts continue to have difficulty in determining what materials were prepared in anticipation of trial and thus deserve limited immunity from discovery.[19]

Generally, courts have focused upon at least five different factors in determining whether or not requested materials fall within the limited immunity of federal rule 26(b)(3).[20] Some courts have examined the

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[11]Duplan Corp. v. Moulinage et Retorderie de Chavanoz, 487 F.2d 480, 483 (4th Cir. 1973); Hercules Inc. v. Exxon Corp. 434 F. Supp. 136, 151 (D. Del. 1977).

[12]329 U.S. at 511.

[13]*Id.*

[14]*Id.*

[15]For a more in-depth look at the potential for unethical conduct and related problems, see Brazil, *The Adversary Character of Civil Discovery: A Critique and Proposals for Change*, 31 VAND. L. REV. 1295 (1978); Levy, *Discovery—Use, and Abuse, Myth and Reality*, 17 FORUM 465 (1982).

[16]329 U.S. at 511.

[17]*Id.* at 512.

[18]*See* Upjohn Co. v. United States, 449 U.S. 382, 398 (1981). In *Upjohn*, the Court stated that "[t]he 'strong public policy' underlying the work product doctrine . . . has been substantially incorporated in Federal Rule of Civil Procedure 26(b)(3)." *Id.* (footnote omitted).

[19]*See* Note, *Work Product Discovery: A Multifactor Approach to the Anticipation of Litigation Requirement in Federal Rule of Civil Procedure 26(b)(3)*, 66 IOWA L. REV. 1277 (1981).

[20]For example, one court required that there be "some possibility" of litigation. *In re* Grand Jury Investigation, 599 F.2d 1224, 1229 (3d Cir. 1979). Others look to see if there was a "prospect" of litigation. Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 604 (8th Cir. 1977). Still others suggest that there must be a "substantial probability" of imminent litigation. Home Ins. Co. v. Ballenger Corp., 74 F.R.D. 93, 101 (N.D. Ga. 1977).

nature of the event that prompted the preparation and the likelihood the event would lead to litigation.[21] The more likely that a particular event would cause parties to litigate in order to protect their interests, the more likely that the materials were prepared or obtained for future litigation. Other courts have considered the timing of the preparation in relation to when specific claims arose or when discussion or negotiation began.[22] Parties who became aware of specific claims and anticipated litigation would likely take action regarding litigation or negotiation soon after the materials were prepared or obtained. The substance of the materials is another factor used to determine the purpose for which the items were prepared or obtained.[23] Documents and statements which contain legal opinions are more likely to have been prepared for litigation than are materials composed of mainly factual information. Whether the materials were prepared or requested by an attorney is a fourth possible consideration.[24] Presumably, if an attorney became involved, it was due to the expectation of litigation. A fifth factor is whether the materials were prepared in the ordinary course of business or for some special purpose.[25] Courts which have emphasized this factor have traditionally found that routine materials would have been prepared regardless of whether or not litigation was anticipated.[26]

The application of these factors and their underlying policies to each factual situation is a challenging task. Many courts have dealt with

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[21]*See* Almaguer v. Chicago, Rock Island & Pac. R.R. Co., 55 F.R.D. 147 (D. Neb. 1972); Ritrovato v. Hartford Ins. Group, 88 Misc. 2d 928, 390 N.Y.S.2d 504 (N.Y. Sup. Ct. 1976) (cases dealing with the particular nature of an accident). In *re* Grand Jury Investigation, 599 F.2d 1224, 1229 (3d Cir. 1979), the court stated, " 'Thus the test should be whether, in light of the nature of the document and factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation.' " *Id.* at 1229 (quoting 8 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2024, at 198 (1970)).

[22]Kent Corp. v. NLRB, 530 F.2d 612, 623-24 (5th Cir.), *cert. denied*, 429 U.S. 920 (1976); Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 335-36, 670 P.2d 725, 733-34 (1983)(en banc); Fireman's Fund Ins. Co. v. McAlpine, 391 A.2d 84, 89 (R.I. 1978).

[23]*In re* Grand Jury Subpoena, 599 F.2d 504, 510-11 (2d Cir. 1979) (holding that there was insufficient evidence to prove that an investigation by management was carried out by the corporation's general counsel); Coastal Corp. v. Duncan, 86 F.R.D. 514, 522 (D. Del. 1980) (stating that the policy behind protection of the opinions and observations of an attorney is the need to uphold the integrity of the adversary process).

[24]*See* Sterling Drug Inc. v. Harris, 488 F. Supp. 1019, 1026 (S.D.N.Y. 1980); Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. 367, 372 (N.D. Ill. 1972).

[25]Westhemeco Ltd. v. New Hampshire Ins. Co., 82 F.R.D. 702, 708 (S.D.N.Y. 1979); Rakus v. Erie-Lackawanna R.R. Co., 76 F.R.D. 145, 146 (W.D.N.Y. 1977); Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. 367, 373 (N.D. Ill. 1972); (Items prepared in the ordinary course of business are discoverable.).

[26]Fine v. Bellefonte Underwriters Ins. Co., 91 F.R.D. 420, 423 (S.D.N.Y. 1981); APL Corp. v. Aetna Casualty & Surety Co., 91 F.R.D. 10, 20 (D. Md. 1980); Westhemeco Ltd. v. New Hampshire Ins. Co., 82 F.R.D. 702, 709 (S.D.N.Y. 1979); Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co., 61 F.R.D. 115, 118 (N.D. Ga. 1972).

only one factor in their decisions. For example, some courts have considered only whether an attorney was involved in the preparation of documents.[27] Other courts have held that any documents prepared in the ordinary course of business are discoverable.[28]

Although a determination based upon one factor may provide a quick solution in a particular case, such decisions are rather arbitrary and tend to overlook the policies behind the limited immunity from discovery. Insurance companies, for example, use a variety of complex procedures in each factual situation, and the application of a single factor test ignores the possible relevance of more than one factor.[29] By focusing upon separate factors, courts can easily reach inconsistent decisions in similar situations. For instance, assume that two insurance companies conduct investigations, without the participation of attorneys, into similar accidents. The documents compiled in each case are similar to those prepared by insurance companies every day. One court may note that no attorney requested or prepared the materials, concluding that the items are discoverable. Another court may examine the nature of the accident and the likelihood that litigation would result from it, finding that the work product doctrine protects the documents because litigation was very probable at the time they were prepared.[30] Such contrary results could be eliminated, or at least reconciled, if courts would expand their analyses to include other factors. Although one factor may be of greater significance in a given case, courts should consider each of the five factors when determining whether or not the requested materials were prepared in anticipation of litigation.

III. Developments and Doubts in Insurance Litigation—Including a Look at Indiana Law*

Recent trends in the area of bad faith actions have had a significant impact on the insurance business. An insurance company that denies a

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[27]Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co., 61 F.R.D. 115 (N.D. Ga. 1972); Henry Enter., Inc. v. Smith, 225 Kan. 615, 592 P.2d 915 (1979).

[28]McDougall v. Dunn, 468 F.2d 468, 473 (4th Cir. 1972); Westhemeco Ltd. v. New Hampshire Ins. Co., 82 F.R.D. 702 (S.D.N.Y. 1979).

[29]Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 335, 670 P.2d 725, 733 (1983)(en banc). *See also* Note, *supra* note 19, at 1286-87.

[30]Such a situation may have occurred in Almaguer v. Chicago, Rock Island & Pac. R.R. Co., 55 F.R.D. 147 (D. Neb. 1972) and Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. 367 (N.D. Ill. 1972). *Thomas Organ* involved damaged cargo; *Almaguer* involved a personal injury claim following a train accident. Both sets of materials were prepared in the ordinary course of business. The *Thomas Organ* court held that the items were readily discoverable because no attorney was involved. 54 F.R.D. at 372. The *Almaguer* court, on the other hand, concluded that a railroad accident is the type of event that could reasonably lead a person to anticipate litigation. Therefore, the statement of a witness in *Almaguer* was protected by federal rule 26(b)(3). 55 F.R.D. at 149. The *Thomas Organ* court could have reached the same conclusion had it not insisted upon direct attorney involvement.

*On February 6, 1985, the Indiana Court of Appeals decided Cigna-INA/Aetna v.

claim may not only be forced to produce relevant files upon a discovery request; it may also have to pay greater damages if found liable for a bad faith breach of contract. The threat of high damage awards and uncertainty regarding discovery are relevant to an insurer's decision concerning a claim. In Indiana, for example, the insurer's decision is affected by a trend toward higher damages and the doubt regarding the proper application of the work product doctrine to insurance litigation.

A. Punitive Damages

One reason that insurance companies are concerned with the controversy over discovery involves the prevalence of claims for punitive damages in bad faith actions.[31] An insurer that chooses to dispute a claim subjects itself to increased liability if the claimant is able to prove that the insurer's decision was carried out in bad faith. The majority of states recognize an insurer's right to question the facts surrounding a claim, or the application of law to a particular claim, before being forced to satisfy the claim; therefore, an insurer is generally liable for punitive damages only in cases involving extreme and outrageous circumstances.[32] Currently, the type of conduct necessary and the standard of proof for recovering punitive damages vary from state to state.[33]

Hagerman-Shambaugh, 473 N.E.2d 1033. An insured brought suit against its insurer following denial of coverage for damage to a construction project. The insured had requested production of "[a]ll memoranda, letters, notes or documents of any nature in possession of the defendant . . . as it relates to the claim . . . which is the subject matter of this lawsuit." The court did not share the insurance company's fear that liberal discovery would cause insurers to forego good faith investigations of claims; it further found that, based on the factual circumstances, the trial court had not abused its discretion in determining that the requested documents had not been prepared in anticipation of litigation and were therefore subject to discovery. *Id.* at 1036-39. This case will receive extensive treatment in the upcoming *Survey of Recent Developments in Indiana Law*, Volume 19, Issue 1, IND. L. REV. (1985).

[31]California led the way in the development of bad faith tort law, and became known for its high bad faith damages awards. For decisions permitting insureds to recover punitive damages against insurers, see Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (fire insurance); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970) (disability insurance); Crisci v. Security Ins. Co., 66 Cal. 2d 425, 58 Cal. Rptr. 13, 426 P.2d 173 (1967) (liability insurance).

[32]Thornton & Blaut, *Bad Faith and Insurers: Compensatory and Punitive Damages*, 12 FORUM 699, 719 (1976-77). For additional discussions of bad faith recovery, see Note, *Good Faith and Fair Dealing in Insurance Contracts:* Gruenberg v. Aetna Insurance Co., 25 HASTINGS L.J. 699 (1974); Note, *The Widening Scope of Insurer's Liability*, 63 KY. L.J. 145 (1975); Note, *The New Tort of Bad Faith Breach of Contract*: Christian v. American Home Assurance Corp., 13 TULSA L.J. 605 (1978); Levine, *Demonstrating and Preserving The Deterrent Effect of Punitive Damages In Insurance Bad Faith Actions*, 13 U.S.F.L. REV. 613 (1979).

[33]Long, *Punitive Damages: An Unsettled Doctrine*, 25 DRAKE L. REV. 870, 879-81 (1976); Mallor & Roberts, *Punitive Damages: Toward a Principled Approach*, 31 HASTINGS L.J. 639, 642 (1980).

The Indiana Supreme Court confronted the trend toward increasing punitive damage claims in *Travelers Indemnity Co. v. Armstrong*.[34] *Armstrong* involved an insured's action to recover the full cost of repairing a building damaged by fire, as well as punitive damages for the insurance company's failure to pay the entire restoration cost.[35] The supreme court held that an insured must prove fraud, deceit, or oppressive conduct by clear and convincing evidence before an award of punitive damages would be justified.[36] Prior to *Armstrong*, the courts applied the preponderance standard, but strong social policy compelled the adoption of this strict standard.[37]

The threat of punitive damages in bad faith actions is of concern to insurers regardless of whether a particular jurisdiction requires clear and convincing evidence, extreme or outrageous conduct, or both.[38] The contents of materials prepared during an insurer's consideration of a claim are relevant in determining whether or not bad faith exists and punitive damages are justified. The tort of bad faith occurs when an insurance company intentionally denies, fails to process, or refuses to pay a claim without a reasonable basis for its action.[39] Whether or not the conduct constitutes bad faith is a matter of reasonableness under the circumstances, so that the materials which embody the insurance company's decisionmaking process are relevant to the issue of bad faith.

The claimant who demonstrates the relevance of the materials to his ability to prove that an insurer acted in bad faith presents a strong basis for allowing discovery of the materials. Of special concern to the insurer is the possibility that a claimant in possession of the documents that indicate the grounds for the insurer's decision will be better able to make a case for punitive damages. Although cases such as *Armstrong* may slow the trend toward increasing punitive damage awards, a claimant has a strong case for acquiring the precise evidence needed to improve his chances of recovering punitive damages. Insurance companies, already uncertain as to how a court will determine whether or not materials were genuinely prepared in anticipation of litigation, may find their defenses weakening and their prospects for successful resistance of claims diminishing if liberal discovery is permitted.

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[34]442 N.E.2d 349 (Ind. 1982).

[35]*Id.* at 352.

[36]*Id.* at 363.

[37]*Id.* at 362-63. Insurers might be forced into payment of questionable claims for fear that disputing any claim could lead to greater liability. Undeserving claims would be paid, resulting in higher insurance rates for all policy holders. *See* Thornton & Blaut, *supra* note 32, at 719. Recently, Indiana enacted legislation requiring clear and convincing evidence of all facts necessary to recover punitive damages in a civil action. IND. CODE § 34-4-34-2 (Supp. 1984).

[38]California appears to have retreated from its previously high standard of care for insurers. California courts have taken the position that although there is proof that an insurer has violated its duty of good faith, the insured has the burden to prove the insurance company's conscious disregard of the rights of the insured, or its intention to vex, injure, or annoy him. Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 462, 113 Cal. Rptr. 711, 718, 521 P.2d 1103, 1110 (1974).

[39]Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 670 P.2d 725 (1983)(en banc).

B. Newton v. Yates*: A Decision Without a Solution*

The relationship among bad faith, punitive damages, and the rules of discovery adds greater confusion to an already uncertain Indiana position regarding the work product doctrine and insurance litigation. The only Indiana case in which such issues have arisen is *Newton v. Yates*.[40] *Newton* involved a personal injury action by the guest passenger of one automobile against the uninsured driver of the other vehicle involved in the accident.[41] In the same proceeding, the plaintiff brought an action against the host driver's insurer for alleged misconduct in handling his claim.[42] The trial court entered judgment for the tort defendants, and granted the insurer's motion for a separate trial on the misconduct claim.[43] In addition, the trial court granted limited immunity from discovery to a majority of the documents sought by the plaintiff.[44]

Because the character of the issues, facts, and evidence regarding the negligence and punitive damages claims would differ and would likely lead to prejudice and confusion, the court of appeals found that the lower court acted properly within its discretion in granting separate trials.[45] The court considered the key guidelines by which a trial court must determine the applicability of Indiana Trial Rule 26(B)(3).[46] First, the requested documents must be relevant to the issues being tried.[47] The court of appeals did not make a determination on this element because the court record included neither the requested materials nor a clear indication of their relevance to the driver's negligence.[48] Instead,

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[40]170 Ind. App. 486, 353 N.E.2d 485 (1976).

[41]*Id.* at 489, 353 N.E.2d at 487.

[42]*Id.*

[43]*Id.*

[44]*Id.* at 491-92, 353 N.E.2d at 489. The requested documentary material included the following:

(a) investigation materials;
(b) recorded statements of all witnesses and parties;
(c) damage estimates;
(d) subrogation agreements;
(e) correspondence between the insurer and the uninsured motorist (Yates);
(f) contracts, agreements, and statements of the insurer that were signed by Yates;
(g) records of payments made by Yates to the insurer;
(h) correspondence between the insurer and the attorney for Yates;
(i) reports of the insurer's agents;
(j) correspondence between the insurer and the owner of a trailer located near the scene of the accident, as well as all investigation reports and photographs of the trailer.

Id.

[45]*Id.* at 490, 353 N.E.2d at 488.

[46]*Id.* at 493, 353 N.E.2d at 490.

[47]*Id.*

[48]*Id.*

the court examined the second guideline, whether or not the materials were protected from discovery by a privilege or immunity.[49]

The court took the approach that work product immunity applies to attorneys, their agents, and the client, and concluded there was no evidence to indicate that the trial court had abused its discretion in determining that the items were not discoverable.[50] The court noted that the files might have been available if the trials had not been separated, but any error was harmless.[51] Because the plaintiff failed to show substantial need or an inability to acquire the equivalent information elsewhere, only one item was discoverable.[52] The *Newton* court deferred to the trial court's discretion, and the resulting opinion lends little assistance to parties in insurance litigation who seek to make or resist a request for discovery.

IV. Approaches to the "Anticipation of Litigation" Issues in Insurance Cases

The two well recognized approaches to the discovery question in insurance litigation establish clear distinctions between materials that must be produced and those that are protected by the work product doctrine. Application of these approaches results in absolute decisions that require very little inquiry into whether or not the requested materials were truly prepared in anticipation of litigation. Neither approach gives full consideration to the policies behind federal rule 26(b)(3).

A. The "Direction of Counsel" Approach

According to one of the absolute approaches, some courts that have considered the materials prepared by an insurer merely have inquired as to who is responsible for the work.[53] Under this approach, if the investigation into a particular claim was not performed at the request or under the direction of an attorney, there is no need for further inquiry. The absence of counsel conclusively indicates that the investigation was routine and not carried out in anticipation of litigation.

Such an approach received its strongest support in *Thomas Organ Co. v. Jadranska Plobodna Plovidba*,[54] a decision that interpreted the 1970 amendments to the federal discovery rules. *Thomas Organ* involved an action to recover damages to cargo carried on the defendants'

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[49]*Id.*

[50]*Id.* at 495, 353 N.E.2d at 491.

[51]*Id.*

[52]*Id.* Only damage estimates were available.

[53]McDougall v. Dunn, 468 F.2d 468 (4th Cir. 1972); Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co., 61 F.R.D. 115 (N.D. Ga. 1972); Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. 367 (N.D. Ill. 1972); Henry Enter., Inc. v. Smith, 225 Kan. 615, 592 P.2d 915 (1979).

[54]54 F.R.D. 367 (N.D. Ill. 1972).

ship.[55] The defendants sought to prove that the plaintiff had failed to design and pack the shipped goods properly. The defendants further attempted to discover two documents written by a marine surveyor who was hired by the plaintiff's insurance company.[56] The court held the documents were not entitled to limited immunity from discovery, and interpreted the amended rule to mean that material that has "not been requested by nor prepared for an attorney nor which otherwise reflects the employment of an attorney's legal expertise must be conclusively presumed to have been made in the ordinary course of business."[57]

In a more recent decision, the Supreme Court of Kansas followed the "direction of counsel" approach and stated that the majority of cases consider lack of attorney participation to be the deciding factor.[58] Although reliance upon this approach makes decisions much easier, courts have criticized such reasoning because the plain language of federal rule 26(b)(3) grants limited immunity to materials prepared " 'by or for another party or by or for that other party's representative.' "[59] Not only could the items have been prepared by a party, but there is no reason to conclude that his representative must have been an attorney. Other representatives may include consultants, sureties, indemnitors, insurers, or agents.[60] Certainly, attorneys are not the only ones who anticipate litigation and prepare for it.

In addition, adherence to such an absolute approach could lead insurance companies to involve attorneys at an earlier point in investigations. The insurer, on the other hand, may simply delay investigation until direct involvement of an attorney can be secured. Eventually, though, such regular programs might encourage courts to consider attorney participation at earlier stages to be a part of ordinary business, thus eliminating the significance of this factor. The delay of an investigation could also result in the loss of useful evidence and hinder the adequate and complete preparation of materials for trial, thus defeating the underlying goal of federal rule 26(b)(3).[61] An overemphasis of the "direction of counsel" approach may result in inconsistent decisions, as previously noted.[62]

Additional questions arise when in-house counsel or attorneys on retainer become involved. Of course, the communications between in-house counsel and a corporation are subject to the attorney-client privilege when an opposing party seeks discovery of relevant materials,[63] so it is likely that materials prepared by in-house counsel, as well as by

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[55]*Id.* at 368.

[56]*Id.* at 368-69.

[57]*Id.* at 372. Such materials are discoverable. *See supra* note 25 and accompanying text.

[58]Henry Enter., Inc. v. Smith, 225 Kan. 615, 621, 592 P.2d 915, 920 (1979).

[59]Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 333, 670 P.2d 725, 731 (1983)(en banc)(quoting ARIZ. R. CIV. P. 26(b)(3)).

[60]*See supra* note 7.

[61]*See* Note, *supra* note 19, at 1292.

[62]*See supra* notes 29-30 and accompanying text.

[63]Malco Mfg. Co. v. Elco Corp., 45 F.R.D. 24 (D. Minn. 1968).

outside attorneys, are entitled to the limited immunity under the work product doctrine. Once again, however, a court might consider early involvement of in-house counsel to be only a sham and part of the insurer's ordinary course of business. The analysis could turn to an examination of the degree to which the attorney was involved, and whether or not the individual attorney anticipated litigation. Therefore, these types of attorney-client arrangements which can lead to routine attorney involvement demonstrate the unreliability and confusion that can result from strict adherence to the "direction of counsel" approach.

B. The "Total Coverage" Approach

A second view holds that all statements and information secured by an insurer after an event which may expose the insurer or its insured to a claim are prepared in anticipation of litigation.[64] *Almaguer v. Chicago, Rock Island & Pacific Railroad Co.*[65] led the way in granting limited immunity to all materials prepared by an insurance company in response to a potential claim. *Almaguer* involved an action by an injured party against his employer.[66] Shortly after the accident took place and two months before the claimant retained an attorney, the defendant's claims agent made a routine investigation and took the written statement of a witness.[67] The trial court granted the document limited immunity from discovery, relying upon cases cited in the Advisory Committee's Note to the 1970 revision of federal rule 26(b)(3), which concluded that statements acquired by a claims agent immediately after an accident are taken in anticipation of litigation.[68]

More recently, the Rhode Island Supreme Court in *Fireman's Fund Insurance Co. v. McAlpine*[69] criticized the majority approach by stating that the "anticipation of litigation" requirement cannot be satisfied simply by the existence of an attorney who oversees the investigation.[70]

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[64]Almaguer v. Chicago, Rock Island & Pac. R.R. Co., 55 F.R.D. 147 (D. Neb. 1972); Fireman's Fund Ins. Co. v. McAlpine, 391 A.2d 84 (R.I. 1978).

[65]55 F.R.D. 147 (D. Neb. 1972).

[66]*Id.* at 148.

[67]*Id.*

[68]*Id.* at 149. The Advisory Committee's Note is located at 48 F.R.D. 497. For examples of cited cases, see Guilford Nat'l Bank v. Southern Ry. Co., 297 F.2d 921 (4th Cir. 1962) (statements obtained by claims agents were not discoverable because both parties had equal access to the witness); Hauger v. Chicago, Rock Island & Pac. R.R. Co., 216 F.2d 501 (7th Cir. 1954) (without showing good cause, an injured employee could not discover statements of witnesses obtained by one of the railroad companies in order to assist its attorneys in preparing a defense, although the decision was not based upon the work product doctrine); Burke v. United States, 32 F.R.D. 213 (E.D.N.Y. 1963) (involving accident reports prepared by employees prior to the initiation of any action, and not protected by the work product rule). In reality, the fact that the first two cases do not discuss the work product doctrine and the third case did not apply federal rule 26(b)(3) limited immunity to accident reports lends little, if any, support to the decision in *Almaguer*.

[69]391 A.2d 84 (R.I. 1978).

[70]*Id.* at 89.

The court likewise rejected a case-by-case approach for its inability to provide uniformity in lower court decisions.[71] Instead, the court followed the *Almaguer* decision and held that because of the litigious nature of society, "when an insured reports to his insurer that he has been involved in an incident involving another person, the insurer can reasonably anticipate that some action will be taken by the other party."[72] This approach considers the "seeds of prospective litigation" to have been sown, resulting in an ever-present possibility of litigation, although early settlement of the insurance claim may preclude litigation.[73]

The *Fireman's Fund* court was quick to point out, however, that under certain circumstances an insurer may conduct an investigation in the ordinary course of business, such as in a case where an accident report is required by law but is not necessarily prepared in response to a threat of litigation.[74] The "total coverage approach" would not apply because the report was prepared in order to fulfill a requirement of law rather than to serve as a help if litigation arose.

Logically, an insurance company that faces a potential claim recognizes the possibility that disagreements over the policy's coverage could lead to litigation. The materials prepared are potentially valuable evidence if the case goes to court, and the insurer naturally would want exclusive access to them. On the other hand, the relevance of documents and statements to potential litigation supports the idea that each party requires knowledge of the contents of the items in order to be prepared adequately and completely for litigation. Courts thus face two conflicting policies in dealing with discovery requests in insurance litigation, policies which demonstrate the inability of absolute approaches such as the "direction of counsel" or "total coverage" views, to provide fair results to both parties.

V. Protection of Insurers and Claimants

In *Upjohn Co. v. United States*,[75] the United States Supreme Court devoted a portion of its discussion to the work product doctrine and the policies behind it. The Court noted that a key reason for protecting certain materials is the need to encourage parties to develop all of the facts and compile a thorough record of each case.[76] Protection of these records allows a party to carry out his quest for information without fear of having his written materials revealed to an opponent.

The foregoing policy is certainly applicable to insurance litigation. In order to provide deserving claimants with fair protection under their

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[71] *Id.* (citing Spaulding v. Denton, 68 F.R.D. 342 (D. Del. 1975)).

[72] 391 A.2d at 89-90.

[73] *Id.* at 90.

[74] *Id.* (citing Nordeide v. Pennsylvania R.R. Co., 73 N.J. Super. 74, 179 A.2d 71 (1962)).

[75] 449 U.S. 383 (1981).

[76] *Id.* at 398.

insurance policies and to avoid payment of illegitimate claims, insurers should be encouraged to conduct complete investigations into possible claims and maintain accurate files of surrounding facts and conclusions. In the *Hickman* case, for example, the Court warned that allowing one party free access to any relevant information possessed by the other would undermine such a policy.[77] If claimants are readily allowed to discover files kept by insurers, the insurers might decide to limit the preparation of documents regarding a particular claim. A request for discovery of such limited files would not likely produce beneficial information for a claimant, and society as a whole would suffer from the incomplete services that insurance companies would provide.

On the other hand, insurance companies are powerful litigators with the ability to acquire a great deal of information. To provide them with complete protection would place insureds at a substantial disadvantage, particularly those who decided to leave the work to the insurance company under the assumption that the claim would be processed without the need for litigation.[78] Additionally, claimants forced to conduct their own investigations would face increased expenses when bringing actions against insurers.[79]

The application of absolute approaches overlooks the need to balance the conflicting policies involved in insurance litigation. Under the "direction of counsel" approach, an insurance company must turn over its file unless an attorney participated in the work, thus ignoring the adverse effect liberal discovery can have upon an insurer's work. The "total coverage" approach protects the insurer, but puts the claimant at a disadvantage, one that could lead deserving claimants to abandon legal action. The policy of encouraging complete and adequate preparation demands a balanced approach that provides each party with the privacy and opportunity necessary for fair adjudication.[80]

VI. Comparing the Facts With the Factors—A Suggested Approach

To avoid arbitrary outcomes which may result from the application of only one factor, the better approach is to examine the facts of each case and their relationship to each one of the five factors used to determine whether or not requested materials were prepared in anticipation of litigation. Because business and claim procedures are complex and greatly varied, no test which employs a single factor will provide an adequate framework for consistent decisions in harmony with the

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[77]329 U.S. at 511.

[78]*See* Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. at 373; Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co., 61 F.R.D. 115, 118 (N.D. Ga. 1972).

[79]Carver v. Allstate Ins. Co., 94 F.R.D. 131 (S.D. Ga. 1982).

[80]*See* Note, *supra* note 19, at 1299.

policies which support the work product doctrine.[81] There will likely be situations in which one or more of the factors will not be as determinative or even as relevant as the others. Nonetheless, consideration of the applicability of each factor is more likely to reveal whether, under the facts surrounding the claim, the person who prepared the items did so with an eye toward litigation.

A. The Nature of the Event Producing the Claim

Admittedly, nearly all circumstances and events which may produce a claim potentially result in litigation.[82] The mere fact that a claim is likely, however, does not mean that the event and its ramifications are likely to be so problematic as to lead to a genuine threat of legal action.[83]

The decision in *Ritrovato v. Hartford Insurance Group*[84] demonstrates how the unique circumstances of an incident can indicate that an insurer immediately began to gather information and prepare documents in anticipation of litigation. In *Ritrovato*, the court focused upon the high level of suspicion regarding the source of a fire that resulted in a claim under a fire insurance policy.[85] The day after the fire, a claims representative of the insurer visited the site of the loss, only to find that the police had sealed off the premises.[86] Upon stopping at the police station, an investigator assigned to the case informed the claims representative that the police considered the fire to be of incendiary origin.[87] The claims agent also saw evidence which supported the suspicion.[88] The court agreed that the evidence was strong enough to lead the insurer to conduct the rest of the investigation in preparation of a defense against the claim and protected the files from disclosure.[89]

The key element in *Ritrovato* was the nonroutine nature of the investigation due to the suspicion surrounding the fire. This consideration is closely tied to another factor: whether or not the investigation was conducted in the ordinary course of business.[90] The *Ritrovato* court did not discuss particular aspects of the investigation that made it abnormal, but clearly found that unusual circumstances surrounding an event could immediately trigger a response from an insurer which indicates that litigation was expected.

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[81]Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 335, 670 P.2d 725, 733 (1983) (en banc).

[82]*See* Almaguer v. Chicago, Rock Island & Pac. R.R. Co., 55 F.R.D. at 149; Fireman's Fund Ins. Co. v. McAlpine, 391 A.2d at 89-90.

[83]Spaulding v. Denton, 68 F.R.D. 342 (D. Del. 1975); Garfinkle v. Arcata Nat'l Corp., 64 F.R.D. 688 (S.D.N.Y. 1974).

[84]88 Misc. 2d 928, 890 N.Y.S.2d 504 (N.Y. Sup. Ct. 1976).

[85]*Id.*

[86]*Id.* at 929, 390 N.Y.S.2d at 504.

[87]*Id.*

[88]*Id.*, 390 N.Y.S.2d at 504-05.

[89]*Id.*, 390 N.Y.S.2d at 505. In Carver v. Allstate Ins. Co., 94 F.R.D. 131 (S.D. Ga. 1982), the court specifically stated that fire loss claims are more likely to lead an insurer to suspect fraudulent or criminal conduct than are other types of property loss claims. *Id.* at 135.

[90]*See infra* notes 146-57 and accompanying text.

Another consideration is the degree of suspicion or resolve on the part of the insurer that is necessary to indicate that the insurer had good reason to conduct its investigation with the intention of ultimately resisting a claim. A problem also surfaces when, after an extensive investigation involving the preparation of a large quantity of documents, the insurer realizes that the nature of the event requires denial of coverage under the appropriate policy.[91]

A set standard for analysis of the likely response from an event with unusual circumstances is probably undesirable, as is a set standard for determining the entire "anticipation of litigation" issue. Some cases which support the suggested approach rely upon an indication that litigation became "probable."[92] Once again, however, the necessary degree of probability is subject to the trial court's discretion, an element that is discomforting to some courts.[93]

Trial court discretion in determining whether and to what extent the special nature of an event would influence an insurer to be suspicious and to conduct its investigation with the intent to defend itself against a claim is not inconsistent with provisions authorizing trial court discretion in other areas.[94] This allowance is especially appropriate in light of the fact that the "nature of the event" factor is only one of five to be used in the total analysis. The disadvantage of allowing discretion is far outweighed by the fair outcome that will result from a consideration of all five factors and their relationship to the facts of each case.

B. The Time of Preparation

Another factor which deserves consideration is the relationship between the time when the insurer became aware of specific claims and the time when the requested materials were prepared.[95] The existence of specific claims presumably would lead a party to prepare materials for

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[91]Naturally, the solution depends upon the relation of the other four factors to the case, although it appears that if a decision to resist the claim occurred after much investigation, the "nature of the event" factor would be of less significance because the insurer did not anticipate litigation during the preparation of the materials.

[92]*See* Carver v. Allstate Ins. Co., 94 F.R.D. 131, 134 (S.D. Ga. 1982) (noting that at some point the probability of litigation becomes "substantial and imminent"). In Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 670 P.2d 725 (1983)(en banc), the court found that litigation was "quite probable." *Id.* at 336, 670 P.2d at 734.

[93]Fireman's Fund Ins. Co. v. McAlpine, 391 A.2d at 89.

[94]*See generally* Friendly, *Indiscretion About Discretion*, 31 EMORY L.J. 747, 760-61 (1982); Greenawalt, *Discretion and Judicial Decision: The Elusive Quest for the Fetters That Bind Judges*, 75 COLUM. L. REV. 359 (1975). In particular, judges exercise broad discretion in pre-trial, trial, and post-trial matters, including decisions regarding extensions of time, amendment of pleadings, selection of jurors, attorney statements, admission of certain kinds of evidence, and granting of new trials. Rosenburg, *Judicial Discretion of the Trial Court, Viewed from Above*, 22 SYRACUSE L. REV. 635, 657-58 (1971).

[95]McDougall v. Dunn, 468 F.2d 468 (4th Cir. 1972); Fontaine v. Sunflower Beef Carrier, Inc., 87 F.R.D. 89, 92 (E.D. Mo. 1980); Hercules Inc. v. Exxon Corp., 434 F. Supp. 136 (D. Del. 1977).

negotiations or litigation which would soon follow. In *Fontaine v. Sunflower Beef Carrier, Inc.*,[96] the plaintiff brought an action for injuries suffered in an automobile accident which allegedly resulted from the negligence of the defendant's driver. On the day of the accident or shortly thereafter, the driver made statements to the defendant's safety director, insurer, and investigator.[97] The plaintiff sought to discover copies of the statements. The court considered the cases involving discovery of materials prepared by insurers as being part of a spectrum.[98] At one end was the "direction of counsel" approach; at the other end was the "total coverage" view.[99] Because the requirement of attorney participation was not in keeping with the language of federal rule 26(b)(3), the court refused to limit the protection to documents prepared only by a party's representative.[100] Similarly, the court expressed concern over the protection of documents prepared by an insurer when litigation was only a possibility.[101]

The *Fontaine* court reasoned that the soundest approach, and the one which best accommodated the "competing considerations involved," was to examine whether or not specific claims were present at the time the documents were prepared.[102] Under the facts of the *Fontaine* case, the court found that the existence of specific claims in connection with the accident indicated litigation was "clearly identifiable," regardless of the fact that no suit had been filed.[103] The identification of the likely plaintiff and the potential claims to be asserted were sufficient to meet the court's requirements.[104]

The insurer's perception of potential claims at the time when the materials were prepared supports the notion that the items could have been intended for use in subsequent litigation. The intent is even more clear when the nature of the claim automatically leads the insurer to suspect that the applicable policy does not cover the claim. Nonetheless, the preparation of documents long before a suit is filed is strong evidence that litigation was not anticipated.[105]

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[96]87 F.R.D. 89 (E.D. Mo. 1980).

[97]*Id.* at 91.

[98]*Id.* at 92.

[99]*Id.*

[100]*Id.*

[101]*Id.* The court referred to Miles v. Bell Helicopter, 395 F. Supp. 1029 (N.D. Ga. 1974), in which concern was expressed regarding the difficulty of differentiating between an investigation conducted in anticipation of litigation and one conducted for other reasons. At the same time, however, the *Fontaine* court refused to follow the *Miles* position that there must be a substantial probability of imminent commencement of litigation.

[102]87 F.R.D. at 92.

[103]*Id.* at 93.

[104]*Id.*

[105]*See* McDougall v. Dunn, 468 F.2d 473 (4th Cir. 1972). The *McDougall* court noted that the time between the preparation and the filing of suit was two and one half years. Also, the court considered an additional factor, the lack of an attorney's involvement. A claims adjuster prepared the statements. *Id.*

As with each factor, total reliance upon the existence or obviousness of specific claims at the time the materials were prepared can produce unfair conclusions. For instance, if an insurer must have only a good idea of the identity and claims of a potential claimant, insurers would take steps to identify likely claimants and probable claims quickly in an effort to protect investigation files from discovery.[106] In addition, an insurer might postpone the preparation of documents until specific claims are known, which could result in the loss of important facts, as well as in inadequate investigations. Claimants would be placed at a severe disadvantage. The insurer's knowledge of the identity of the claimant and the nature of the claim certainly does not necessarily indicate that the insurer plans to oppose the claimant and face litigation.

The requirement of the existence of specific claims and an identifiable plaintiff could result in injustice to an insurer who investigates an occurrence or the activities of its insured when the insurer expects to find evidence of a violation that would remove the event or disqualify an insured from insurance coverage. Certainly, an insurer could plan to use the information to defend itself in the future. An unexpected claimant could later appear with a different theory for recovery, or the insured could file a claim for something not necessarily considered during the investigation. If an insurer does not know of the specific claims or of a probable claimant, the materials prepared during the investigation would be discoverable, leaving an insurer's defense plan open to opposing parties.[107] Even the Supreme Court appears to recognize that specific claims do not have to exist during the preparation of materials in order for work product immunity to apply.[108]

Although the amount of time between the preparation of documents and the existence of specific claims cannot conclusively indicate an anticipation of litigation, this factor deserves consideration. This factor is particularly significant when an insurer immediately becomes aware that a particular claim or claimant is not likely covered by an insurance agreement, resulting in an investigation intended to prepare the insurer's defenses.

C. The Existence of Legal Opinions

Discovery rules applicable in federal and Indiana courts provide additional immunity to statements and materials containing "mental impressions, conclusions, opinions, or legal theories of an attorney or

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[106]Fontaine v. Sunflower Beef Carrier, Inc., 87 F.R.D. at 93.

[107]*Id.*

[108]In *Upjohn Co. v. United States*, 449 U.S. 383 (1981), corporate documents compiled during an internal investigation into allegedly illegal activities were not discoverable when the government later initiated tax summons enforcement proceedings. Although the investigation took place prior to the time specific claims arose, or the time when the Internal Revenue Service became aware of the activities, the court held that work product immunity applied. *Id.* at 398-99.

other representative of a party concerning the litigation."[109] This immunity precludes discovery even if the requesting party has shown substantial need and an inability to obtain similar information without undue hardship. There is a dispute, however, as to the extent of such immunity. Some courts consider the immunity to be an absolute one.[110] Total immunity would pose a significant obstacle to a party attempting to proceed against an insurer.[111] As previously noted, an action against an insurance company for a bad faith breach of contract necessitates the claimant's acquisition of evidence regarding the denial of his claim.[112] Therefore, when mental impressions, opinions, or conclusions are directly at issue in a case, courts often permit an exception to strict protection.[113]

Not all courts permit discovery in bad faith actions, even though the plaintiff alleges that the mental impressions of an insurer's agents and employees are the subject matter of the lawsuit.[114] In *North Georgia Lumber & Hardware v. Home Insurance Co.*,[115] an insured sued an insurer for failure to pay for a property loss allegedly covered by a fire insurance contract. The court held that the issue of bad faith would be resolved at trial, based upon the strength or weakness of the insurer's defense.[116] The mental impressions of the insurer's agents during or after the investigation was not the test by which the bad faith of the insurer was analyzed.[117] In addition, the court found that the amount of information compiled by the insurer did not increase or decrease the risk taken by the defendant in its refusal to pay the claim.[118] The *North Georgia* court held that a good faith defense required a reasonable and probable cause for making the decision, and that such a defense was a complete defense to the action.[119] Therefore, the plaintiff could not

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[109]FED. R. CIV. P. 26(b)(3). *See supra* note 7. The composition of a protected mental impression is not clearly defined. Particular categories of opinion work product include strategies, intended lines of proof, evaluations of the strengths and weaknesses of a case or defense, and inferences drawn from available facts. *See* Cooper, *Work Product of the Rulesmakers*, 53 MINN. L. REV. 1269 (1969); Note, *Protection of Opinion Work Product Under the Federal Rules of Civil Procedure*, 64 VA. L. REV. 333 (1978).

[110]Duplan Corp. v. Moulinage et Retorderie de Chavanoz, 509 F.2d 730 (4th Cir. 1974), *cert. denied*, 420 U.S. 997 (1975); United States v. Chatham City Corp., 72 F.R.D. 640, 643 n.3 (S.D. Ga. 1976).

[111]*See* Carver v. Allstate Ins. Co., 94 F.R.D. 131, 134-35 (S.D. Ga. 1982); Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 336, 670 P.2d 725, 734 (1983)(en banc).

[112]*See supra* notes 38-39 and accompanying text.

[113]Donovan v. Fitzsimmons, 90 F.R.D. 583 (N.D. Ill. 1981); Truck Ins. Exch. v. St. Paul Fire & Marine Ins. Co., 66 F.R.D. 129 (E.D. Pa. 1975); Bird v. Penn Cent. Co., 61 F.R.D. 43 (E.D. Pa. 1973).

[114]North Georgia Lumber & Hardware v. Home Ins. Co., 82 F.R.D. 678 (N.D. Ga. 1979).

[115]82 F.R.D. 678 (N.D. Ga. 1979).

[116]*Id.*

[117]*Id.*

[118]*Id.*

[119]*Id.*

successfully argue that the opinions of the agents were the subject matter of a bad faith lawsuit.[120]

Some courts have permitted a party in insurance litigation to delete all portions of documents which contain opinions before producing the remainder to the requesting party.[121] Such a result would appear to provide fairness to both parties: the claimant receives a substantial portion of the relevant information, and the insurance company is able to protect its ideas and strategy for use in litigation. At the same time, however, there may be no reason to withhold the entire document. As one court reasoned, "[I]n focusing on the question of whether documents containing mental impressions are discoverable, the parties have begged the more dispositive question in this dispute."[122] In *Carver v. Allstate Insurance Co.*,[123] the court noted that the real issue is whether or not the materials were prepared in anticipation of litigation. Another approach to the issue is to determine whether the opinions were recorded with a belief that such opinions would serve as a basis for defenses against a claim.

Indeed, a statement in which a claims investigator or an attorney indicated his belief that a claimant was not entitled to recovery would constitute strong proof that, at least from that point forward, the investigation was conducted with an eye toward preparing a defense.[124] Of course, a similar statement to the effect that a valid claim existed could indicate that a routine investigation was still taking place. If two or more opinions conflicted, it would be difficult to reach any conclusion regarding the direction of an investigation at the time, unless, of course, one opinion deserved much greater weight.[125] For this reason, a court should consider all five factors rather than focusing only on the absence or existence of mental impressions and like factors.

Claims agents, as well as attorneys, often prepare reports or memoranda that reflect their mental impressions or personal evaluations of a factual situation, especially when litigation is expected.[126] Yet, the fact that a document contains a person's opinions does not necessarily preclude an opposing party's right to obtain the information relevant to his case. Absolute protection of such documents could lead insurers to saturate all materials compiled during an investigation with even the most insignificant opinions in order to prevent potential claimants from preparing adequate cases. Nonetheless, if an insurer expects litigation and seeks to prepare defenses against a claim, the insurer should be entitled to

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[120]*Id.*

[121]Southern Ry. Co. v. Lanham, 403 F.2d 119, 133 (5th Cir. 1968); Home Ins. Co. v. Ballenger Corp., 74 F.R.D. 93, 102 (N.D. Ga. 1977).

[122]Carver v. Allstate Ins. Co., 94 F.R.D. 131, 133-34 (S.D. Ga. 1982).

[123]94 F.R.D. 131 (S.D. Ga. 1982).

[124]*Id.* at 134. *See also* Westhemeco Ltd. v. New Hampshire Ins. Co., 82 F.R.D. 702, 708 (S.D.N.Y. 1979).

[125]For instance, an attorney's opinion regarding a questionable claim could be a strong influence upon an insurer's decision to begin building a defense file.

[126]Southern Ry. Co. v. Lanham, 403 F.2d 119 (5th Cir. 1968).

keep legal theories and strategies from an opposing party. Without such protection, a claims adjuster or other representative might refuse to report all of his thoughts and ideas concerning a claim. The nonexistence of reliable records might disrupt an insurance company's evaluation process and result in unreliable evaluation and disposition of claims.[127]

The existence of opinions and mental impressions in the requested materials should lead courts to examine how the facts and the course of the investigation relate to the legal analyses expressed. The content of the documents, in conjunction with the other four factors, will give some indication as to the direction of the insurer at the time the items were prepared.

D. Attorney Involvement

Although an overemphasis upon the preparer of the requested documents can arbitrarily shift the focus away from the underlying question in insurance litigation,[128] an examination of who requested or prepared the materials may reveal the purpose of the work. As previously stated, federal rule 26(b)(3) provides work product immunity to items prepared by a party or its representative.[129] No direct attorney involvement is necessary. If attorney involvement were required, the rule could simply state that materials prepared or requested by an attorney are protected. Instead, the rule requires an additional aspect: that the party or representative must have prepared or requested the items in anticipation of litigation. Courts, however, do consider a client's relationship with his attorney to be significant in relation to discovery requests. For instance, the attorney-client privilege provides protection to communications between a client and his lawyer.[130] The protection is supported by the policy that legal communications should be encouraged.[131] Complete protection, however, can also result in hardship to a party if it is necessary to have the information for the administration of justice, in which case courts may not apply the privilege.[132] It is a matter of balancing competing policies. Although such a privilege is often claimed in cases involving the discovery of documents, courts are quick to point out that the attorney-client privilege is separate from the work product doctrine.[133]

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[127]Carver v. Allstate Ins. Co., 94 F.R.D. at 134.

[128]*See supra* notes 53-63 and accompanying text.

[129]*See supra* note 7.

[130]Prichard v. United States, 181 F.2d 326 (6th Cir. 1950), *aff'd mem.*, 339 U.S. 974 (1950). *See also* Note, *The Attorney-Client Privilege: Fixed Rules, Balancing, and Constitutional Entitlement*, 91 HARV. L. REV. 464 (1977); Note, *Attorney-Client Confidentiality: A New Approach*, 4 HOFSTRA L. REV. 685 (1976).

[131]Wisconsin Lime & Cement Co. v. Hultman, 306 Ill. App. 347, 28 N.E.2d 801 (1940).

[132]Jackson v. Pillsbury, 380 Ill. 554, 44 N.E.2d 537 (1942).

[133]Hickman v. Taylor, 329 U.S. 495 (1947); Daniels v. Hadley Memorial Hosp., 68 F.R.D. 583 (D.D.C. 1975); Halford v. Yandell, 558 S.W.2d 400 (Mo. Ct. App. 1977).

The involvement of an attorney and the subsequent effect upon insurance litigation also requires a balancing of two policies.[134] An attorney's work should be protected to encourage him to prepare his case completely and adequately. On the other hand, a claimant should also be given the opportunity to prepare his case adequately.

Courts that have rejected the majority view that attorney involvement is necessary for application of work product immunity have, nonetheless, considered the existence or absence of attorney input to be a relevant factor.[135] There are several reasons to give weight to an attorney's participation, or lack thereof, in preparing the documents sought by a claimant. First, special consideration should be given to an attorney's work to encourage a complete analysis of a particular claim. Second, the inclusion of an attorney's input into an investigation signals the likelihood of legal opinions and the possible presence of legal strategy. Third, when an insurance company retains counsel to handle a particular investigation or claim, there is good reason to suspect that the insurer has a special purpose for its decision.

The analysis is ultimately determined by the basic question of why the attorney requested or prepared the materials. Certainly, an attorney may become involved in an investigation with the intention that he will oversee and conduct the routine investigation, not expecting to uncover information that will eventually lead to litigation. Moreover, an attorney may merely become involved in an effort to evaluate the legitimacy of a claim. Such situations do not provide good grounds for the conclusion that the attorney's work was done in anticipation of litigation.[136]

At a certain point, however, an attorney's role becomes more indicative of an intention to prepare a defense against a claim.[137] In *Carver v. Allstate Insurance Co.*,[138] for example, an insured sought to recover insurance proceeds and statutory penalties for the insurer's alleged bad faith refusal to pay a loss. The court examined the involvement of attorneys at various stages in the investigation, and referred to the "direction of counsel" approach.[139] The early stages of the investigation were routine in that the management was primarily concerned with the decision of whether or not to pay the claim.[140] Following the preparation of standard reports, however, the activity shifted from mere claims

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[134]*See supra* notes 10-17 and accompanying text.

[135]Fine v. Bellefonte Underwriters Ins. Co., 91 F.R.D. 420, 422 (S.D.N.Y. 1981); Spaulding v. Denton, 68 F.R.D. 342, 345 (D. Del. 1975); Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 336, 670 P.2d 725, 734 (1983)(en banc).

[136]*See* Fine v. Bellefonte Underwriters Ins. Co., 91 F.R.D. 420 (S.D.N.Y. 1981); APL Corp. v. Aetna Casualty & Sur. Co., 91 F.R.D. 10 (D. Md. 1980) (cases involving attorney participation which did not exclude the materials from discovery).

[137]Carver v. Allstate Ins. Co., 94 F.R.D. at 134-35; Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 336, 670 P.2d 725, 734 (1983)(en banc).

[138]94 F.R.D. 131 (S.D. Ga. 1982).

[139]*Id.* at 135.

[140]*Id.* at 134-35.

evaluation to a plan under which litigation became much more likely.[141] Because the claimed monetary loss was substantial and the cause of the loss was suspicious, a senior claims representative became involved.[142] During his investigation, the senior representative sent various reports to Allstate's claims attorneys, a fact upon which the court relied to find that corporate counsel had closely monitored the activity.[143] Finally, the file was turned over to an Allstate defense attorney.[144]

The involvement of attorneys at various stages in the investigation significantly indicated a shift in the course of the investigation. The *Carver* case is uniquely significant for its consideration of four of the relevant factors, and especially for its demonstration that a non-attorney can produce investigative reports that fall within the qualified protection of the work product doctrine.[145]

Carver is also a good example of a court's examination of the reason for the attorneys' involvement. An insurer's decision to retain counsel, especially lawyers designated as defense attorneys, should signal to a court that the investigation had taken a course likely to lead to litigation. Of course, as the *Carver* decision revealed, the other factors are necessary to determine the reason for the attorney's involvement and the purpose behind the materials he requested or prepared.

E. Whether Preparation Was Routine or for a Special Purpose

The last factor requires an examination of the relationship between the preparation of the materials and the insurance company's ordinary course of business. This factor is especially applicable to insurance companies, which naturally operate under an aura of anticipation of litigation.[146] For example, the nature of the insurance business requires that an insurer investigate a claim before determining the appropriate response.[147] Such an investigation is routine, and the materials compiled during the early stages of the investigation are generally discoverable unless the insurer is able to show the participation of an attorney or some other factor which would invoke work product immunity.[148] Never-

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[141] *Id.*

[142] *Id.* at 135.

[143] *Id.*

[144] *Id.*

[145] The court considered the suspicious nature of the fire, the routine nature of the early stages of the investigation, the involvement of counsel, and the existence of opinions and mental impressions.

[146] APL Corp. v. Aetna Casualty & Sur. Co., 91 F.R.D. 10, 17 (D. Md. 1980); Westhemeco Ltd. v. New Hampshire Ins. Co., 82 F.R.D. 702, 708-09 (S.D.N.Y. 1979); Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co., 61 F.R.D. 115, 118 (N.D. Ga. 1972).

[147] Thomas Organ Co. v. Jadranska Plobodna Plovidba, 54 F.R.D. 367 (N.D. Ill. 1972).

[148] *See* Carver v. Allstate Ins. Co., 94 F.R.D. at 134; Fine v. Bellefonte Underwriters Ins. Co., 91 F.R.D. 420, 422 (S.D.N.Y. 1981); Henry Enter., Inc. v. Smith, 225 Kan. 615, 621-22, 592 P.2d 915, 920-21 (1979).

theless, an insurance company's routine investigation of claims does not negate the insurer's genuine anticipation of litigation at an early point in the case. The existence of other factors can indicate that the investigation was not routine from the very beginning.[149] The policy favoring complete and adequate preparation of cases contrasts with an insurance company's claim that it should not be forced to turn over materials prepared by its agents or other employees because insurers always anticipate litigation to some extent. It is interesting to note, however, that some courts refuse to designate an insurer's investigation files as ordinary preparation that is outside the protection of the work product doctrine.[150]

In *Almaguer v. Chicago, Rock Island & Pacific Railroad Co.*,[151] the court held that the statement taken by a claims agent following a railroad accident in which an employee was injured was taken in anticipation of litigation. The court found the investigation was routine, but that it was a "reasonable assumption" that legal action would ensue.[152] A contrary decision was reached in *Spaulding v. Denton*,[153] a case involving a yacht accident that was followed by an investigation by a marine surveyor hired by the insurer in an effort to gather all of the available information. The *Spaulding* court found that the reports, which were unusual in the sense that the insurer did not normally order an outside investigation, were materials prepared in the ordinary course of business and were discoverable.[154] Both cases involved somewhat unusual accidents and routine inquiries, but the courts reached different conclusions.

Such inconsistent results can be avoided only by examining the nature of the investigation and the purpose behind it. The fact that insurers ordinarily investigate accidents and potential claims does not eliminate the possibility that an insurer expected the investigation to result in the denial of a claim and subsequent legal action.

There are several items courts should consider when analyzing this factor. Certain reports prepared during an investigation are standard, and would have been prepared whether litigation was anticipated or not. Usually, the only purpose of the report is to assist the insurer in its decision whether or not to resist the claim.[155] Another signal to which

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[149]Ritrovato v. Hartford Ins. Group, 88 Misc. 2d 928, 929, 390 N.Y.S.2d 504, 505 (N.Y. Sup. Ct. 1976). For a discussion of this case, see *supra* notes 83-88 and accompanying text.

[150]Almaguer v. Chicago, Rock Island & Pac. R.R. Co., 55 F.R.D. 147, 149 (D. Neb. 1972); Fireman's Fund Ins. Co. v. McAlpine, 391 A.2d 84, 89-90 (R.I. 1978); Ainsworth v. Union Free School Dist. No. 2, Queensbury, 38 A.D.2d 770, 771, 327 N.Y.S.2d 873, 875 (1972).

[151]55 F.R.D. 147 (D. Neb. 1972).

[152]*Id.* at 149.

[153]68 F.R.D. 342 (D. Del. 1975).

[154]*Id.* at 346.

[155]*See generally* Carver v. Allstate Ins. Co., 94 F.R.D. at 134-35; APL Corp. v. Aetna Casualty & Sur. Co., 91 F.R.D. 10, 20 (D. Md. 1980). In *APL Corp.*, the court referred to a description of the insurance company's routine investigation procedures given in a deposition. Naturally, any court should be well informed as to how the insurer normally investigates an accident or claim and what purpose is served at each stage. *Id.*

courts should be alerted is a significant change from the pattern of routine operations. For instance, once initial reports are examined, the insurer may provide new instructions.[156] The investigation could become more intense, or particular inquiries may reveal suspicions on the part of the insurer. Of course, outright denial of a claim is the indicator to some courts that an insurance company's course of business is shifting from routine activities to an anticipation of litigation.[157]

In addition, the unusual nature of the event, the existence of specific claims or legal opinions, and attorney participation can indicate that an investigation was a departure from the usual procedures. All five factors are interdependent and should be considered when searching for the purpose behind materials prepared by an insurer.

VII. Conclusion

Because insurance companies are engaged in the business of anticipating litigation, the application of discovery rules requires a close examination of the circumstances surrounding the preparation of requested documents. Analysis of the "anticipation of litigation" issue with regard to only one of the relevant factors results in inconsistent decisions. Courts should consider all five factors and their relation to the complex and varied business and claims procedures of insurance companies before concluding that certain items were or were not prepared with a sufficient expectation of legal action. In some situations, a particular factor may be inapplicable or of less significance, but application of all relevant factors will result in decisions consistent with the policies behind the work product doctrine.

This Note has revealed the inadequacies of reliance upon a single factor, as well as the problems which currently face insurers and claimants when the issue of discovery arises. Courts should address the following five issues in their analysis of whether or not materials were prepared in anticipation of litigation: (1) whether or not the nature of the event was such that insurers and claimants would be inclined to expect litigation; (2) whether or not specific claims existed at the time the items were prepared, and in what manner they influenced the investigation; (3) whether or not the materials contained legal opinions that were relevant to the action or were of such a nature that they deserved protection; (4) whether or not an attorney requested or prepared the materials, and the nature of his role; and, (5) whether the materials were prepared in

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[156]Spaulding v. Denton, 68 F.R.D. at 346.

[157]Carver v. Allstate Ins. Co., 94 F.R.D. at 134-35; APL Corp. v. Aetna Casualty & Sur. Co., 91 F.R.D. 10, 18 (D. Md. 1980); Brown v. Superior Court In & For Maricopa County, 137 Ariz. 327, 336, 670 P.2d 725, 733-34 (1983)(en banc). *But see* Westhemeco Ltd. v. New Hampshire Ins. Co., 82 F.R.D. 702, 708 (S.D.N.Y. 1979) (insurer notified the plaintiff that it was denying liability for the claim, but further negotiations and cooperation between the parties indicated that the investigation continued to be conducted in a routine way).

the usual course of the insurer's business or whether they indicated that litigation was expected.

The foregoing factors are closely related, and all should be considered in light of the work product doctrine and the policy of encouraging adequate and complete preparation for trial. Only through the application of all such considerations can insurers and claimants expect fair and consistent decisions.

Brian Woodward

Applying Res Judicata in Antitrust Cases: *Marrese* Provides an Approach, But Few Answers

I. Introduction

Federal courts have long been plagued by the question of what effect, if any, a state court judgment[1] should have on a subsequent federal antitrust suit[2] involving the same parties[3] and based on the same operative facts.[4] Bringing a federal antitrust suit after a state court action causes the confrontation of two strongly-held legal principles:[5]

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[1]The issue of the effect of a state court judgment on a subsequent federal antitrust suit has arisen not only when the original action was a state antitrust action, *see* Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d 1347 (9th Cir. 1983); Nash County Board of Education v. Biltmore Co., 640 F.2d 484 (4th Cir.) *cert. denied*, 454 U.S. 878 (1981); Straus v. American Publishers' Ass'n, 201 F. 306 (2d Cir. 1912), but also after state contract actions, *see* Marrese v. American Academy of Orthopaedic Surgeons, 105 S. Ct. 1327 (1985); Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980), and following a state unfair competition suit, *see* Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967). Additionally, the issue has been addressed where a state defendant brought a federal antitrust suit after raising the federal antitrust laws as a defense against a state contract action. *See* Lyons v. Westinghouse Electric Corporation, 222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955) (collateral estoppel).

[2]Federal antitrust actions have been brought under the Sherman Antitrust Act, 15 U.S.C. §§1-7 (1982), *see* Marrese v. American Academy of Orthopaedic Surgeons, 105 S. Ct. 1327 (1985), and Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d at 1348; under the Clayton Antitrust Act, 15 U.S.C. §§ 12, 13, 14-21, 22-27 (1982), *see* Hayes v. Solomon, 597 F.2d 958, 960 (5th Cir. 1979); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358, 363 (6th Cir. 1967); and under the Robinson-Patman Act, 15 U.S.C. §§ 13-13b, 21a (1982), *see* Lyons v. Westinghouse Electric Corporation, 222 F.2d 184, 185 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955) (action also based on Clayton Act).

For the purpose of analyzing the issue of res judicata, there is no significant difference between the federal antitrust statutes cited. *See infra* note 8.

[3]The same issue is involved if "privies" of parties to the original action are parties in the subsequent suit. *See, e.g.*, Nash County Board of Education v. Biltmore Co., 640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

[4]*See, e.g.*, Marrese v. American Academy of Orthopaedic Surgeons, 726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985); Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d 1347 (9th Cir. 1983); Nash County Board of Education v. Biltmore Co., 640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981); Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967); Lyons v. Westinghouse Electric Corporation, 222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955); Straus v. American Publishers' Ass'n, 201 F. 306 (2d Cir. 1912).

[5]Often the goals and underlying principles of the policies of res judicata and exclusive federal jurisdiction are at odds, especially in the context of parallel antitrust regulation by both the federal and state governments. *See, e.g.*, Marrese v. American Academy of Orthopaedic Surgeons, 726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985); Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d 1347 (9th Cir. 1983); Nash County Board of Education v. Biltmore Co., 640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981); Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert.*

res judicata[6] and exclusive federal jurisdiction.[7] Historically, the courts, deeming the two principles to be mutually exclusive, have based their

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denied, 444 U.S. 1078 (1980). *See generally* Rubin, *Rethinking State Antitrust Enforcement*, 26 U. FLA. L. REV. 653 (1974); Note, *The Res Judicata Effect of Prior State Court Judgments in Sherman Act Suits: Exalting Substance Over Form*, 51 FORDHAM L. REV. 1374, 1374-75, nn.3-4 (1983).

Among the other areas in which res judicata and exclusive federal jurisdiction may clash are cases involving patents, *see, e.g.*, Becher v. Contoure Laboratories, Inc., 279 U.S. 388 (1929); bankruptcy, *see, e.g.*, Brown v. Felsen, 442 U.S. 127 (1979); *In re* Houtman, 568 F.2d 651 (9th Cir. 1978); and securities regulation, *see, e.g.*, Connelly v. Balkwill, 174 F. Supp. 49 (N.D. Ohio 1959), *aff'd per curiam*, 279 F.2d 685 (6th Cir. 1960). *See generally* Note, *Exclusive Federal Court Jurisdiction and State Judgment Finality - The Dilemma Facing the Federal Courts*, 10 SETON HALL L. REV. 848 (1980); Note, *Res Judicata: Exclusive Federal Jurisdiction and the Effect of Prior State-Court Determinations*, 53 VA. L. REV. 1360 (1967). *See also* Dickinson, *Exclusive Federal Jurisdiction and the Role of the States in Securities Regulation*, 65 IOWA L. REV. 1201 (1980); Note, *Res Judicata and Collateral Estoppel in Bankruptcy Discharge Proceedings*, 37 WASH. & LEE L. REV. 281 (1980).

[6]Res judicata, also known as "claim preclusion," provides that "a final judgment on the merits bars further claims by parties or their privies based on the same cause of action." Montana v. United States, 440 U.S. 147, 153 (1979). *See also* Kremer v. Chemical Construction Corp., 456 U.S. 460-61, n.6 (1982). *See generally* 18 C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4402 (1981).

The elements essential for the application of res judicata include: (1) a final judgment on the merits in an earlier suit, (2) an identity of the cause of action in both suits, and (3) an identity of the parties or their privies in both suits. Nash County Board of Education v. Biltmore Co., 640 F.2d 484, 486 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

The doctrine of res judicata is often confused with the doctrine of collateral estoppel, which provides another means by which a prior suit can affect a current suit. Collateral estoppel, also known as issue preclusion, "bars the relitigation of issues actually adjudicated, and essential to the judgment, in a prior litigation between the same parties." Kaspar Wire Works, Inc. v. Leco Engineering & Machine, Inc., 575 F.2d 530, 535-36 (5th Cir. 1978); *see also* Cromwell v. County of Sac, 94 U.S. 351, 352-53 (1876).

Like res judicata, collateral estoppel requires a prior suit between parties or privies to the present suit and a final judgment on the merits in that suit. Unlike res judicata, however, application of collateral estoppel does not require that the cause of action in both suits be the same. The only requirements for collateral estoppel are that the issue common to both suits actually was litigated in the first suit and that its adjudication was essential to the judgment in the first action. *See* 18 C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4402 (1981).

The purposes of the doctrine of res judicata are to promote fairness to the defendant, to preserve judicial resources by bringing adjudication to a conclusion with reasonable promptness, and to prevent inconsistent decisions in separate actions on the same claim. *See* Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d 1347, 1350 (9th Cir. 1983); F. JAMES & G. HAZARD, CIVIL PROCEDURE, § 11.2 at 531-32 (2d ed. 1977).

[7]Whereas res judicata seeks to promote judicial economy and consistency, exclusive federal jurisdiction promotes the uniform national application of a law. Congress has granted the federal courts exclusive jurisdiction to decide claims arising under certain federal laws. *See generally* 18 C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4470 (1981).

One of the goals of this grant of exclusive federal jurisdiction is the uniform interpretation of federal laws through review by judges who have expertise in administering the federal laws and who have a sensitivity to the national concerns which the federal laws are intended to address. F. JAMES & G. HAZARD, CIVIL PROCEDURE, § 11.2 at 530 (2d ed. 1977).

decisions on their evaluation of whether a federal antitrust action, considered to be within the exclusive jurisdiction of the federal courts,[8] can constitute the same claim or cause of action[9] as a state suit brought in state court.[10] Until recently, courts have generally asserted that exclusive jurisdiction considerations precluded the possibility of res judicata being applied.[11] Since 1981, three courts of appeals have held that applying res judicata is appropriate where doing so would significantly compromise the underlying purposes of neither res judicata nor exclusive federal jurisdiction.[12] In these instances, the two policies, previously thought to be irreconcilable, were harmonized. In contrast to the earlier suits[13] where exclusive federal jurisdiction considerations generally prevailed, these recent appellate court decisions have favored applying res judicata to preclude the federal suit.[14] The Supreme Court reviewed the most recent of these cases.

In its review, the Supreme Court had the opportunity to establish definitive standards to be applied uniformly by the lower courts in determining when a federal antitrust suit following a state action should

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[8]Unlike the statutes in several other areas of law (*see supra* note 5), the federal antitrust statutes do not explicitly state that federal courts have exclusive jurisdiction over federal antitrust actions. However, the United States Supreme Court has held that enforcement of federal antitrust laws is within the exclusive jurisdiction of the federal courts. *See, e.g.*, General Investment Co. v. Lake Shore & Michigan Southern Ry. Co., 260 U.S. 261, 287 (1922); Blumenstock Brothers Advertising Agency v. Curtis Publishing Co., 252 U.S. 436, 440-41 (1920). *See also* State of Washington v. American League of Professional Baseball Clubs, 460 F.2d 654, 658 (9th Cir. 1972).

[9]Res judicata is to be applied to preclude a subsequent action only where the same claim was, or could have been, brought in a previous suit between the parties or their privies. *See* Brown v. Felsen, 442 U.S. 127, 131 (1979).

[10]The dilemma, neatly stated by one commentator, is that "[n]either legislative history nor judicial pronouncement [indicates] whether Congress's grant of an exclusive remedy [under the antitrust laws] rests upon a policy so strong as to immunize the federal courts from the effect of state court judgments." Comment, *Exclusive Federal Jurisdiction: The Effect of State Court Findings*, 8 STAN. L. REV. 439, 447 (1956). *But see infra* note 121 and accompanying text.

[11]*See, e.g.*, Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967); Lyons v. Westinghouse Electric Corp., 222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955); Straus v. American Publishers' Ass'n, 201 F. 306 (2d Cir. 1912). *See also infra* notes 34-51 and accompanying text.

[12]*See* Marrese v. American Academy of Orthopaedic Surgeons, 726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985); Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d 1347 (9th Cir. 1983); Nash County Board of Education v. Biltmore Co., 640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

[13]*See, e.g.*, Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967); Lyons v. Westinghouse Electric Corp., 222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955) (collateral estoppel).

[14]*See* Marrese v. American Academy of Orthopaedic Surgeons, 726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985); Derish v. San Mateo-Burlingame Board of Realtors, 724 F.2d 1347 (9th Cir. 1983); Nash County Board of Education v. Biltmore Co., 640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

be precluded. The Supreme Court adopted a test[15] based on the Full Faith and Credit Statute,[16] an approach completely unlike those utilized in any appellate court decision in the antitrust context.[17] Unfortunately, the Court did not totally settle the issue because it failed to give guidance on how to apply its test.[18] As a result, federal district courts can be expected to use methods and reach decisions as varied as those prior to the Supreme Court pronouncement.

A review of the cases reveals the wide variety of factors, considerations, and approaches used by the courts when confronted with the issue of the preclusive effect of a state court judgment on a subsequent federal antitrust suit. This Note will discuss the various historical approaches to this question, will analyze the Supreme Court's 1985 decision on the issue, and will recommend an appropriate method of implementing the Supreme Court's approach.

II. Historical Development

The courts' analyses in the early cases can be divided into three categories. In *Straus v. American Publishers' Association*,[19] the court based its determination primarily on equitable considerations rather than on a reasoned balancing of res judicata and exclusive federal jurisdiction considerations, noting that the plaintiff's original choice to file the action in state court should preclude him from bringing substantially the same suit in the federal forum.[20] In a second line of cases, *Lyons v. Westinghouse Electric Corporation*,[21] *Cream Top Creamery v. Dean Milk*

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[15]Marrese v. American Academy of Orthopaedic Surgeons, 105 S. Ct. 1327 (1985). *See also infra* note 121, and text accompanying notes 119-124.

[16]28 U.S.C. § 1738 (1982) provides in pertinent part that authenticated Acts by state legislatures or "records and judicial proceedings" of state courts: "shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken." The full faith and credit statute requires, therefore, that federal courts give preclusive effect to prior state court judgments. *See generally* Atwood, *State Court Judgments in Federal Litigation: Mapping the Contours of Full Faith and Credit*, 58 Ind. L.J. 59 (1982).

The full faith and credit statute should be distinguished from the Full Faith and Credit Clause, article IV, section 1 of the United States Constitution, which states that "Full Faith and Credit shall be given in each State to the public Acts, Records, and Judicial Proceedings of every other State," and generally requires that state courts give preclusive effect to the judgments of courts in other states.

[17]While the circuit courts of appeals generally have approached the issue involved in the seven principal cases analyzed (*see* cases cited *supra* note 4) as a confrontation between exclusive federal jurisdiction and res judicata (or, as in *Lyons*, collateral estoppel), these courts generally have given little, if any, attention to the full faith and credit statute, 28 U.S.C. § 1738.

[18]*See infra* notes 131, 140-43 & 151-52 and accompanying text.

[19]201 F. 306 (2d Cir. 1912).

[20]*See infra* text accompanying notes 27-33.

[21]222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955).

Company,[22] and *Hayes v. Solomon*,[23] the courts found exclusive federal jurisdiction considerations compelling. These courts reasoned that, because the state court could not adjudicate federal antitrust suits, the claims in the two actions were different. Therefore, because res judicata applied only where the same claim was involved in two actions, exclusive federal jurisdiction required that the second suit not be precluded. Finally, in *Nash County Board of Education v. Biltmore Company*,[24] *Derish v. San Mateo-Burlingame Board of Realtors*,[25] and *Marrese v. American Academy of Orthopaedic Surgeons*,[26] the courts determined that a state claim could be equivalent to a federal antitrust action if the state and federal statutes were similar enough in terms of damages, standard of liability, and procedural safeguards. If the state and federal claims were equivalent, these courts said, res judicata should apply to preclude the federal suit.

A. Straus v. American Publishers' Association: *A Scout for the Proponents of Choice*

The first case to address the res judicata question in the federal antitrust context was decided in 1912. In *Straus v. American Publishers' Association*,[27] Straus sued American Publishers' Association in the Supreme Court of New York, alleging an illegal conspiracy by the publishers comprising the Association.[28] Although the state court prohibited certain activities of the Association and awarded damages to Straus, the court order did not prohibit the Association from all the activities Straus had alleged were illegal.[29] While Straus was appealing this state court decision to the United States Supreme Court, he brought suit in federal district court against many of the same defendants alleging federal antitrust violations. The federal district court held that res judicata precluded the federal suit, and Straus appealed.[30]

The Second Circuit Court of Appeals applied res judicata principles to bar the federal suit, based primarily on the fact that the plaintiff in both suits originally had his choice of bringing suit in the state or federal court.[31] Having elected to sue in state court, the plaintiff should not

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[22]383 F.2d 358 (6th Cir. 1967).

[23]597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980).

[24]640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

[25]724 F.2d 1347 (9th Cir. 1983).

[26]726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985).

[27]201 F. 306 (2d Cir. 1912).

[28]Straus alleged that the publishers comprising the Association were illegally conspiring to supply materials only to distributors who agreed to sell the materials at the suggested retail price. *Id.* at 308.

[29]The court order only prohibited the Association from interfering with Straus's purchases of uncopyrighted materials, but did not extend to the Association withholding copyrighted materials from Straus. *Id.*

[30]*Id.* at 309.

[31]*Id.* at 310.

later be permitted to sue in federal court.[32] The court dismissed as unimportant the exclusive federal jurisdiction argument.[33]

B. Proponents of Exclusive Federal Jurisdiction

The federal appeals courts' next opportunity to address the res judicata claim in the federal antitrust context again fell to the Second Circuit. That court, unconcerned with exclusive federal jurisdiction in the *Straus* case decided forty-three years earlier, deemed this principle important enough in *Lyons v. Westinghouse Electric Corporation* to hold that the earlier state suit did not preclude a federal action.[34] Although the issue in *Lyons* involved collateral estoppel, the Second Circuit Court of Appeals' decision that a state court's factual determinations in a prior state antitrust suit had no effect on a subsequent federal antitrust action[35] had a far-reaching impact on later courts' decisions to apply res judicata to preclude a subsequent federal antitrust suit.[36] Although the court could have distinguished *Lyons* from *Straus*, it did not do so and, some commentators argue, overruled *Straus*.[37]

In the *Lyons* case, Westinghouse originally had sued Lyons in state court for breach of contract. As a defense, Lyons alleged that Westinghouse had violated state antitrust laws. The state trial court held for Westinghouse, indicating that Lyons had failed to prove the antitrust charges. While Lyons' appeal of the state action was pending, he sued Westinghouse in federal court on federal antitrust charges. The federal district court stayed the federal proceedings until disposition of the state appeal. Westinghouse appealed the stay. The Second Circuit Court of Appeals ordered the district court to proceed with the trial because the state appeal could have no effect on the federal action.[38]

In reaching its decision, the *Lyons* court indicated that collateral estoppel[39] clearly did not apply because of the grant to the federal courts of exclusive jurisdiction over federal antitrust actions.[40] This rule applied,

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[32]*Id.*

[33]"The fact that the judgment in the state court depended upon the state statutes and that the complaint in this case is founded on the federal statute, which is not within the jurisdiction of the state court, makes no difference," the unanimous court declared. *Id.* at 310.

[34]222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955).

[35]*Id.* at 190.

[36]*See, e.g.*, Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967).

[37]*See, e.g.*, Note, *The Res Judicata Effect of Prior State Court Judgments in Sherman Act Suits: Exalting Substance Over Form*, 51 FORDHAM L. REV. 1374, 1382-83; Note, *Res Judicata: Exclusive Federal Jurisdiction and the Effect of Prior State Court Determinations*, 53 VA. L. REV. 1360, 1367 (1967).

[38]*Lyons*, 222 F.2d at 190.

[39]*See supra* note 6.

[40]222 F.2d at 189. *Lyons* involved the Clayton and Robinson-Patman acts rather than the Sherman Act which was involved in *Straus* and in most post-*Lyons* res judicata cases. *See supra* note 2.

the court stated, "at least on occasions, like those at bar, where the putative estoppel includes the whole nexus of facts that makes up the wrong."[41] "[E]ffective and uniform" enforcement of federal antitrust laws "would best be achieved by an untrammelled jurisdiction of the federal courts," the court declared.[42] In this case, it concluded that the drawbacks inherent in holding two sets of trials—one state and one federal—were more than offset by the benefits of allowing the federal courts to exercise jurisdiction uninhibited by previous state court rulings.[43]

The Sixth Circuit Court of Appeals continued to emphasize the significance of exclusive federal jurisdiction determining the effect of a prior state court action on a subsequent federal antitrust suit in *Cream Top Creamery v. Dean Milk Company*.[44] Cream Top Creamery sued Dean Milk Company in state court on a state unfair competition charge. The suit was dismissed with prejudice, and Cream Top sued Dean in federal court on federal antitrust charges.[45] The Sixth Circuit Court of Appeals, citing *Lyons*, pointed out that federal courts have exclusive

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[41]222 F.2d at 189. The holding by the Second Circuit Court of Appeals directly conflicted with a 1929 United States Supreme Court ruling in Becher v. Contoure Laboratories, Inc. 279 U.S. 388 (1929). In *Becher*, an inventor sued in state court on a state contract action after his employee surreptitiously obtained a patent on an item invented by the employer. The court imposed on the employee a constructive trust of the patent in favor of the inventor. The employee subsequently sued the inventor in federal court alleging patent infringement. *Id.* at 389-90. Although enforcement of patent laws was within the exclusive jurisdiction of the federal courts, *id.* at 390, the Supreme Court held that the employee was estopped to challenge the facts found in the state suit, even though such estoppel effectively determined the outcome of the federal patent case. *Id.* at 391-92. "That decrees validating or invalidating patents belong to the Courts of the United States does not give sacrosanctity to facts that may be conclusive upon the question in issue," the Court said. *Id.* at 391.

The Second Circuit, in a weak attempt to differentiate *Becher* from *Lyons*, asserted that *Becher* dealt only with giving effect to specific "constituent facts," whereas *Lyons* involved "the entire congeries of such facts, taken as a unit." *Lyons*, 222 F.2d at 188. Estoppel should apply to the *Becher* facts, but not to those in *Lyons*, the Second Circuit claimed. *Id.*

In a later case involving bankruptcy, an area within the exclusive jurisdiction of the federal courts, the United States Supreme Court held that res judicata would not apply to preclude an action in federal bankruptcy court following a state collection suit. Brown v. Felsen, 442 U.S. 127, 138-39 (1979). The court noted in dicta, however, that "collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues [decided in the previous state action] in bankruptcy court." *Id.* at 139, n.10.

[42]222 F.2d at 189.

[43]*Id.* at 190. The court also acknowledged that the plaintiff in the federal suit had been the defendant in the state suit. *Id.* at 189. Unlike the plaintiff in *Straus*, the federal plaintiff in *Lyons* did not have the opportunity to choose the original forum for the action. *Id.* Some commentators have argued that Judge Hand should have differentiated *Lyons* from *Straus* on this basis and have criticized him for failing to do so. *See, e.g., Exalting Substance Over Form, supra* note 37, at 1382-83; *Prior State Court Determinations, supra* note 37, at 1367.

[44]383 F.2d 358 (6th Cir. 1967).

[45]*Id.* at 360-61.

jurisdiction over federal antitrust actions[46] and that the state court could not have granted the relief sought by Cream Top in the federal action.[47] The second suit was not precluded because the state case "did not and could not have involved a claim under the federal anti-trust statutes" and, therefore, "the dismissal with prejudice in the state action could not have adjudicated Dean's alleged violations of these statutes."[48]

In *Hayes v. Solomon*,[49] the Fifth Circuit Court of Appeals agreed that a decision in a state contract action did not preclude a subsequent federal antitrust action under res judicata principles, and that res judicata applied only to claims " 'then capable of recovery' in the first action."[50] Res judicata did not apply because the state court could not have provided the federal antitrust damages sought in the second action, the court said.[51]

C. Nash *and Its Progeny—Res Judicata Wins the Battle*

Cream Top Creamery and *Hayes* represented the state of the law until 1981. In that year, the Fourth Circuit, in *Nash County Board of Education v. Biltmore Company*,[52] held that a state antitrust action could have a res judicata effect on a subsequent federal antitrust suit if the two actions were based on the same fact situation and if the state and federal antitrust laws were the same.[53]

In *Nash*, the attorney general of North Carolina brought an antitrust action in state court against Biltmore Company and eight other dairies, alleging conspiracy to restrain price competition in violation of state law and seeking injunctive relief and treble damages. A consent judgment was issued. Shortly thereafter, the Nash County Board of Education, in its own behalf and seeking to represent a class including those school districts that had purchased dairy products from the offending companies, sued in federal court the same dairies as had been named in the attorney

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[46]*Id.* at 363. The court went on to quote the Second Circuit Court of Appeals' decision in International Railways of Central America v. United Fruit Co., 373 F.2d 408, 419 (2d Cir.), *cert. denied*, 387 U.S. 921 (1967), which stated that "the utmost effect the prior judgment could have had . . . would . . . have been as an estoppel on questions of fact actually litigated." *Cream Top Creamery*, 383 F.2d at 363. The estoppel did not apply here because "there were no findings of fact and no adjudication of the case on its merits in the State Court action." *Id.*

[47]383 F.2d at 363.

[48]*Id.*

[49]597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980).

[50]*Id.* at 984 (quoting United States v. Pan-American Petroleum Co., 55 F.2d 753, 782 (9th Cir.), *cert. denied*, 287 U.S. 612 (1932)).

[51]597 F.2d at 984. The court further stated that the state trial court lacked jurisdiction over the federal antitrust claim and, citing *International Railways*, the *Hayes* court stated: "A plaintiff's successfully suing in a state court on a claim that might have been but was not made the basis for state or federal antitrust relief does not bar a subsequent federal antitrust suit." 597 F.2d at 984.

[52]640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

[53]*Compare supra* notes 27-33 and accompanying text.

general's state suit. Nash sought only treble damages. The district court granted the defendants' motion for summary judgment, ruling that the federal suit was barred under the doctrine of res judicata. The Board appealed.[54]

Using a three-element test of "(1) a final judgment on the merits in an earlier suit; (2) an identity of the cause of action in both the earlier and the later suit, and (3) an identity of parties or their privies in the two suits,"[55] the Fourth Circuit Court of Appeals determined that res judicata applied to preclude the federal suit.[56] The court first cited authority indicating that a consent judgment constituted a final judgment on the merits,[57] thus satisfying the first element.[58] The third requirement was also met because in the state suit the attorney general had represented the Nash County Board of Education and other school districts which purchased milk products from the defendants.[59]

The primary issue in this case, as in most similar federal antitrust suits, was whether the federal antitrust count constituted the same "cause of action" or claim as the state suit. The *Nash* court noted that the term "cause of action" has no standard application and "depend[s] largely on the facts of each case . . . . [I]n some cases, it has depended for its application on whether the facts in the two cases are the same; in other cases, on whether the same primary right is asserted."[60] Here, the court said, regardless of which test was used, the causes of action in both suits were the same.

Although courts in previous suits had held that a federal antitrust suit constituted a different cause of action from a state antitrust action,[61] the *Nash* court asserted that "the identity of two actions, as intimately tied together as these two, [would] not be destroyed in the *res judicata* context simply because the two suits are based on different statutes."[62] The court pointed out that, except for the federal interstate commerce requirement, the two statutes were identical.[63] The real issue in determining whether res judicata applied was whether the two suits "involve[d] the same 'operative facts' and the same basic 'delict' or wrong."[64]

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[54]640 F.2d at 486.

[55]*Id. See supra* note 6.

[56]640 F.2d at 487.

[57]*See generally*, Note, *Civil Procedure, Res Judicata: Exclusive Federal Jurisdiction and State Court Consent Judgments, Fourth Circuit Review*, 39 WASH. & LEE L. REV. 501 (1982).

[58]640 F.2d at 486-87.

[59]*Id.* at 495-96.

[60]*Id.* at 487-88.

[61]*See, e.g., Cream Top Creamery*, 383 F.2d 358 (6th Cir. 1967). *See also supra* notes 34-51.

[62]*Nash*, 640 F.2d at 488.

[63]*Id.*

[64]*Id.*

The Fourth Circuit distinguished *Nash* from *Hayes v. Solomon*[65] and *Cream Top Creamery v. Dean Milk Company*,[66] by indicating that the state antitrust law in North Carolina, like the federal statute, allowed for treble damages, while the applicable state antitrust laws in *Hayes* and *Cream Top Creamery* failed to provide for treble damages.[67] The *Nash* court held that a suit brought in state court under North Carolina's antitrust statute, modeled after the federal statute and including the same right to treble damages, precluded a subsequent federal antitrust suit in federal court.[68]

In the case of *Derish v. San Mateo-Burlingame Board of Realtors*,[69] decided in December of 1983, the Ninth Circuit Court of Appeals followed the Fourth Circuit by holding that a prior state antitrust action barred the state plaintiff from bringing a subsequent federal antitrust suit. The Derishes brought suit in state court against the San Mateo-Burlingame Board of Realtors and others, alleging violations of the state antitrust statute.[70] The trial court dismissed the complaint with prejudice, and the appellate court affirmed. The California Supreme Court declined to review the appellate court decision.[71]

Following the trial court decision, the Derishes filed a Sherman Act suit in federal court against the defendants in their state action.[72] When the state court decision became final, the Board and the other defendants moved to dismiss the federal suit on res judicata grounds. The district court denied the motion, but certified the question for interlocutory appeal.[73] The Ninth Circuit reversed the lower court decision, holding that the dismissal with prejudice in the prior state action barred the federal antitrust suit.[74]

The Derishes had argued that res judicata did not apply because the state and federal actions did not involve the same claim.[75] In determining whether the same claim was involved in both actions, the court considered four questions:

> (1) whether rights or interests established in the prior judgment would be destroyed or impaired by prosecution of the second

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[65]597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980).

[66]383 F.2d 358 (6th Cir. 1967).

[67]640 F.2d at 490.

[68]*Id.*

[69]724 F.2d 1347 (9th Cir. 1983).

[70]The Derishes had sold their house through a broker who used a multiple listing service operated by the San Mateo-Burlingame Board of Realtors. After the sale, the Derishes brought their state action against the Board. In their complaint, the Derishes alleged that limiting the use of the listing service to licensed real estate brokers and salesmen violated the Cartwright Act, CAL. BUS. & PROF. CODE §§ 16700-60 (West 1964 & Supp. 1983). 724 F.2d at 1348.

[71]724 F.2d at 1348.

[72]*Id.*

[73]*Id.*

[74]*Id.*

[75]*Id.* at 1349.

> action; (2) whether substantially the same evidence was presented in the two actions; (3) whether the two suits involved infringement of the same right; and (4) whether the two suits arose out of the same transactional nucleus of facts.[76]

These questions, the court stated, were "tools of analysis, not requirements, because identity of claims 'cannot be determined precisely by mechanistic application of a simple test.' "[77] Focusing on the four questions, the court determined that the state and federal suits "involved the same transactional nucleus of facts, and . . . that substantially the same evidence" would be required in both actions.[78] In determining whether the two suits involved the infringement of the same right, the court said its test would be whether the state and federal statutes "set the same standards for defining unreasonable restraints and imposing liability . . . ."[79] Res judicata should not be applied, the court stated, if the federal law imposed stricter liability standards than those in the state law.[80] The court noted that the federal and state antitrust actions involved here were similar and that the Derishes had not identified any difference in the substantive law of the two statutes. The Derishes' rights under both laws were the same.[81]

Regarding the remaining question posed, the *Derish* court said the Board's "right . . . to be free from this claim as established in the state suit would be destroyed or impaired by the federal suit."[82] Therefore, the court concluded, answers to all four questions supported a res judicata finding.[83]

In analyzing exclusive federal jurisdiction considerations, the court said there were times res judicata should not be applied.[84] The *Derish* case, however, "[did] not involve such factors that would persuade us, without further analysis, to forego res judicata and find an implied exception" to the federal full faith and credit statute.[85] Therefore, the court said, it must go on to "balance the general policies behind exclusive

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[76]*Id.*

[77]*Id.* (quoting Abramson v. University of Hawaii, 594 F.2d 202, 206 (9th Cir. 1979)). The *Derish* court noted that exclusive federal jurisdiction added "another dimension" to this case, 724 F.2d at 1349, and asserted that "[i]t is by weighing these competing policies of exclusive federal jurisdiction and res judicata that a proper decision may be reached." *Id.*

[78]724 F.2d at 1349.

[79]*Id.* at 1350.

[80]*Id.*

[81]*Id.*

[82]*Id.*

[83]*Id.*

[84]As an example, the court cited cases involving discharge of a debt in bankruptcy where "Congress clearly specified the exclusive jurisdiction of the bankruptcy court in this area." *Id.* at 1351.

[85]*Id. See infra* notes 119-21 and accompanying text for a discussion of the Supreme Court's interpretation of the full faith and credit statute.

federal jurisdiction against those of res judicata.''[86] The state case would not hinder uniform interpretation of the Sherman Act because the state case would not be precedent in federal antitrust cases.[87] Further, the traditional ''expertise of federal judges'' argument[88] was met because state court judges were experienced in trying antitrust claims, applying federal law collaterally in state cases.[89] The remedies under both the federal and state laws were the same,[90] as were the opportunities for a jury trial and for discovery proceedings consistent with federal due process requirements.[91] Therefore, the court concluded, the policies supporting exclusive federal jurisdiction would not be ''heavily implicated'' if the federal suit were precluded.[92]

On the other hand, the policies supporting res judicata would be heavily implicated.[93] These policies included removing most of the trial from crowded court dockets, sparing the Board from paying much of the expense involved with defending a claim against which it already had defended, upholding '' '[t]he principles of comity and repose embodied' ''[94] in the federal full faith and credit statute,[95] avoiding possible inconsistent results in the state and federal trials, and fostering ''[c]onsidered reliance on both state and federal judiciary to resolve disputes.''[96] The *Derish* court ultimately concluded that ''[w]hen both state and federal law offer a plaintiff equally sharp teeth for enforcing the same claim he may indeed have but 'one bite at the apple.' ''[97]

In January, 1984, just one month after *Derish* was decided, the Seventh Circuit Court of Appeals followed the Fourth and Ninth circuits in precluding a federal antitrust suit after the federal plaintiff had brought a state action against the same defendant based on the same fact situation. In *Marrese v. American Academy of Orthopaedic Surgeons*,[98] the court

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[86]724 F.2d at 1351.

[87]*Id.*

[88]*See supra* note 7.

[89]*Derish*, 724 F.2d at 1351-52.

[90]*Id.* at 1351.

[91]*Id.* at 1352. The court distinguished previous cases in which courts did not apply res judicata, *see, e.g.*, Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967), by indicating that, in those cases, the state law did not provide for treble damages as did the federal law. 724 F.2d at 1351 (citing Hayes v. Solomon, 597 F.2d 958 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (6th Cir. 1967); Lyons v. Westinghouse Electric Corp., 222 F.2d 184, 189 (2d Cir. 1955)). Here, the state and federal damage provisions were the same, 724 F.2d at 1351, as was the right to a jury trial. *Id.*

[92]724 F.2d at 1351.

[93]*Id.* at 1352.

[94]*Id.* (citing Kremer v. Chemical Construction Corp., 456 U.S. 461, 463 (1982)); *see infra* note 119.

[95]*See supra* notes 6 & 10 and *see infra* notes 175-181 and accompanying text.

[96]*Derish*, 724 F.2d at 1352.

[97]*Id.*

[98]726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985).

extended the *Nash* and *Derish* reasoning to a situation in which the original state suit was not an antitrust suit but rather was a state contract action.

In *Marrese*, two orthopedic surgeons, Drs. Marrese and Treister, sought admission to the American Academy of Orthopaedic Surgeons. Their applications were rejected without a hearing and the doctors sued, alleging breach of contract and due process violations. The state appellate court ordered Treister's complaint[99] dismissed for failure to state a claim, and the state supreme court denied leave to appeal. After losing in the state appellate court, the doctors brought a federal antitrust suit seeking damages and injunctive relief. The federal district court denied the Academy's motion to dismiss the claim based on res judicata and refused to certify the res judicata question for immediate appeal. When the Academy, in violation of a court order, refused to cooperate in pretrial discovery, the district court held the Academy in criminal contempt. The Academy appealed the contempt citation and the underlying refusal to dismiss the federal suit on res judicata grounds.[100]

The Seventh Circuit noted that Drs. Marrese and Treister could have alleged state antitrust violations in their state suit but did not do so.[101] In language reminiscent of the "choice of forum" reasoning in *Straus*,[102] the *Marrese* court pointed out other options which the doctors originally had open to them: they could have brought state or federal antitrust suits or they could have brought both federal and state antitrust suits simultaneously in federal court, joining the state claims through pendent jurisdiction.[103]

The plurality opinion in *Marrese*[104] acknowledged that while the state and federal statutes involved in *Nash* were virtually identical,[105] the

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[99]Dr. Marrese was not a party to Dr. Treister's appeal, but Marrese's suit was stayed pending the outcome of Treister's appeal. After the appeal was denied, Marrese's suit was dismissed. *Id.* at 1151.

[100]*Id.* at 1151-52.

[101]*Id.* at 1152.

[102]*See supra* text accompanying notes 27-33.

[103]726 F.2d at 1152.

[104]As noted by Judge Cudahy, Judge Posner's opinion in *Marrese* was joined by a majority of the nine-member panel on the second issue in the case involving the validity of a contempt judgment after the order on which the citation was based was deemed invalid. However, on the res judicata issue, two judges joined Judge Posner, and two judges joined Judge Cudahy's stinging dissent on the res judicata issue, which charged that "[t]he plurality opinion is in fact an aggressive *tour de force*—going well beyond existing law—in the abdication of federal jurisdiction." *Id.* at 1174 (Cudahy, J., dissenting). Judge Eschbach wrote a concurrence and dissent, concurring on discovery but dissenting on res judicata, *id.* at 1162 (Eschbach, J., concurring and dissenting); Judge Bauer concurred in the result, *id.* (Bauer, J., concurring), and Judge Flaum dissented on discovery but concurred on res judicata, although Judge Flaum reached a res judicata finding through an entirely separate route from Judge Posner, *id.* at 1163 (Flaum, J., concurring and dissenting). The final count was five judges favoring a res judicata finding—although no more than three could agree on the reasoning—and four against it.

[105]*See supra* text accompanying note 63.

statutes here were not.[106] Nevertheless, the statutes did not need to be identical for res judicata to apply. Instead, the decisions should be based on "the specific provisions of the state and federal statutes, read in light of the specific allegations of the complaint. If, applied to the particular case, the state and federal standards are the same, it should not matter that applied to some other case they might be different."[107]

The court considered two possible areas in which the standards might be different. First, the court observed that the liability standards, although different when applied in some cases, were the same here.[108] Second, the damage provisions of the two laws were considered. Under federal law, violations were subject to an automatic tripling of actual damages; the state statute, on the other hand, provided that damages awarded could be *up to* three times the amount of actual damages, but only if the violation was willful.[109] Although the doctors requested damages in their state suit, damages were only sought on a state contract theory.[110] However, the court noted that the doctors' "federal antitrust suit contain[ed] no reference to the facts underlying the breach of contract claim."[111] This and other facts[112] in the case satisfied the *Marrese* court that the doctors were not concerned about treble damages.[113] The plurality concluded that a state antitrust suit would have been a "perfect substitute" for the federal antitrust action.[114]

The court began with the premise that because the doctors could have joined a state antitrust action with their other state claims, a federal antitrust action should be precluded if the state and federal antitrust laws were "materially identical."[115] It concluded that the "materially identical" standard was met.[116] Therefore, the court held, based on res judicata principles, the doctors were barred from bringing the federal suit.[117]

III. The Supreme Court Decision in *Marrese*: The Full Faith and Credit Statute Controls

The United States Supreme Court, in reversing the Seventh Circuit's decision in *Marrese v. American Academy of Orthopaedic Surgeons*,[118]

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[106]726 F.2d at 1155.

[107]*Id.*

[108]*Id.*

[109]*Id.* at 1155-56. Compare the great reliance placed on equivalent state and federal damage provisions in *Derish*, *see supra* note 91, with the relative insignificance the *Marrese* court placed on the differences in state and federal damage provisions.

[110]726 F.2d at 1156.

[111]*Id.*

[112]The court cited the fact that the doctors filed the federal antitrust action more than four years after the contract action was filed and the doctors' supposed concern that they could not show any actual damages—a prerequisite for collecting treble damages—as indicators that they were not really interested in recovering damages. *Id.*

[113]*Id.*

[114]*Id.*

[115]*Id.* at 1153.

[116]*Id.* at 1156.

[117]*Id.*

[118]105 S. Ct. 1327 (1985).

reiterated the test regarding preclusion of a federal suit following a state action developed in its 1982 decision in *Kremer v. Chemical Construction Corporation*[119] and followed in 1984 in *Migra v. Warren City School District Board of Education*,[120] and extended its applicability to a claim

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[119]456 U.S. 461 (1982). In *Kremer*, the Supreme Court had faced the confrontation of res judicata principles and section 1738 in the context of the concurrent jurisdiction of federal and state courts in employment discrimination cases. Rubin Kremer, the employee charging discrimination, was one of a number of workers laid off by his employer. Unlike many of his co-workers who were laid off at the same time, Kremer was not rehired. He filed a discrimination charge with the Equal Employment Opportunity Commission (EEOC) which lacked jurisdiction over the charge until the appropriate state agency, the New York State Division of Human Rights, had had sixty days to handle the matter. The discrimination charge was referred to the state agency, which concluded that no probable cause for a finding of discriminatory practices by the employer existed. Kremer pursued his claim through the administrative and judicial review procedures established by state law. The determination of the state agency was affirmed at each stage. During the pendency of the state judicial review, Kremer again filed with the EEOC, which reached the same finding as had the state agency. He then brought in the district court a claim under Title VII which ultimately was dismissed on res judicata grounds. *Id.* at 463-66.

Beginning with section 1738 as the basis for its analysis and decision, the Supreme Court in *Kremer* noted that section 1738 required "federal courts to give the same preclusive effect to state court judgments that those judgments would be given in the courts of the State from which the judgments emerged." *Id.* at 466 (footnote omitted). Citing a New York statute, the Supreme Court determined that state law would preclude the federal litigation under Title VII. *Id.* at 466-67.

Having determined that the action was precluded under state law, the final inquiry required examining Title VII to ascertain whether an express or implied exception to section 1738 existed which would allow the federal suit to advance. *Id.* at 468. The Court found no express exception or repeal of Section 1738 in the language of Title VII. *Id.* at 469-70. Furthermore, the Supreme Court noted that "[s]ince an implied repeal must ordinarily be evident from the language or operation of a statute, the lack of such manifest incompatability between Title VII and § 1738 is enough to answer our inquiry." *Id.* at 470. To the contrary, the Court determined that the state antidiscrimination laws were integral to the legislative scheme established by Congress. *Id.* at 468-69. Finally, the legislative history revealed no indication of a congressional intent for Title VII to repeal section 1738 and its effect. *Id.* at 470-76.

As an aside, the Supreme Court noted that the concepts of comity and federalism underlying section 1738 are not "compromised" by applying preclusion rules to Title VII cases:

> On the contrary, stripping state court judgments of finality would be far more destructive to the quality of adjudication by lessening the incentive for full participation by the parties and for searching review by state officials. Depriving state judgments of finality not only would violate basic tenets of comity and federalism . . . , but also would reduce the incentive for States to work towards effective and meaningful antidiscrimination systems.

Id. at 478 (*citing* Board of Regents v. Tomanio, 446 U.S. 478, 491-92 (1980)).

[120]104 S. Ct. 892 (1984). In *Migra*, the Supreme Court was confronted with the same concerns faced in *Kremer*, except now in the context of an allegation of constitutional rights violations asserted under 42 U.S.C. §§ 1983 and 1985.

In the prior state court suit, Ethel Migra, a teacher whose appointment was withdrawn shortly after its renewal, asserted a breach of contract claim and a wrongful interference with contractual relations claim against the school board and its individual members. The state court reinstated Migra to her teaching position, awarded her compensatory damages,

within the *exclusive* jurisdiction of the federal court.[121] The Court's two-step analysis looks first to the law of the state in which the state court judgment was rendered. If that state's law would allow a subsequent federal antitrust suit, the second suit is permitted. If the state law would preclude the second suit, the federal court then must perform the second step in the test. At this stage, the court must determine whether the antitrust statute underlying the second suit provides for actions under that statute to be exempted from the provisions of the Full Faith and Credit Statute.[122] If the court finds an express or implied exception

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but dismissed any claim regarding the liability of the individual board members. Subsequently, Migra filed an action in federal court, asserting that her due process and equal protection rights had been violated. Her federal claims arose under the first, fifth, and fourteenth amendments to the Constitution and under sections 1983 and 1985. The federal court dismissed the federal action based on res judicata and statute of limitations. *Id.* at 894-95.

After briefly reviewing the concepts regarding the effect of state court judgments and their preclusive effect under state law enunciated in *Kremer* and Allen v. McCurry, 449 U.S. 90, 96 (1980), the Supreme Court restated the appropriate test that "*in the absence of federal law modifying the operation of [section] 1738*, the preclusive effect in federal court of petitioner's state-court judgment is determined by Ohio law." 104 S. Ct. at 896 (emphasis added). Thereafter, the court examined whether section 1983 created an exception to section 1738, focusing on the decision of *Allen v. McCurry*, which had decided the question as to issues actually litigated in the state court proceeding. *Id.* at 896-97. Finding the reasoning of *Allen* equally applicable to both issue preclusion and claim preclusion, the court held that section 1983 did not "override" section 1738 and that Ohio law must determine the claim preclusive effect of the prior state court judgment. *Id.* at 898.

The Supreme Court then examined the development of the claim preclusion law in Ohio, noting the recent broadening of its applicability. *Id.* at 898-99. Nonetheless, the specific issue confronting the Supreme Court had not been addressed in Ohio. Recognizing that the role of interpreting Ohio preclusion law belonged in the federal district court rather than in the Supreme Court, the *Migra* court remanded the case to the federal district court. *Id.* at 899.

[121]105 S. Ct. at 1332. None of the Supreme Court's earlier decisions had specifically applied the two-part analysis implicitly required by section 1738 to a claim within the exclusive jurisdiction of the federal courts. However, the court reached its decision without addressing any special characteristics or special interests of exclusive federal jurisdiction which may support a different analysis or may dictate the weighing of different concerns. Rather, the court first noted that state res judicata law had precluded a subsequent action under patent law, a law within the exclusive jurisdiction of the federal courts, although the Supreme Court had reached this decision without application of section 1738. *Id.* (citing Becher v. Contoure Laboratories, Inc., 279 U.S. 388 (1929)). Second, while recognizing that it *had not* determined whether Title VII claims were limited to federal jurisdiction, the Supreme Court nonetheless stated that *Kremer* "implie[d] that absent an exception to [section] 1738, state law determines at least the issue preclusion effect of a prior state judgment in a subsequent action involving a claim within the exclusive jurisdiction of the federal courts." 105 S. Ct. at 1332. Finally, the court relied on *Kremer* for its determination that section 1738 requires the preclusive effect of a state court judgment to be ascertained through the application of state law. *Id.* After stating these three concepts, the Supreme Court summarily concluded "that the basic approach adopted in *Kremer* applies in a lawsuit involving a claim within the exclusive jurisdiction of the federal courts." *Id.*

[122]28 U.S.C. § 1738 (1982).

to these provisions, the court hearing the second suit need not give full faith and credit to the judgment in the first action; therefore, the second suit is permitted.[123] If no exception is found, full faith and credit must be afforded to the initial judgment and the second action is precluded.[124]

The Seventh Circuit Court of Appeals erred, the Supreme Court held, when it failed to consider whether the law of Illinois, the state in which the initial suits by Drs. Marrese and Treister were brought, would preclude the second suit. Instead, both the plurality opinion[125] and Judge Flaum's concurrence[126] incorrectly "express[ed] the view that Section 1738 [the Full Faith and Credit Statute] allows a federal court to give a state court judgment greater preclusive effect than the state courts themselves would give it."[127] Because the lower courts had failed to determine whether Illinois state law required preclusion of the federal Sherman Act suit, the Supreme Court remanded the case to the district court to determine whether, under Illinois law, the federal action would be barred.[128]

Although the majority declined to examine whether Illinois law would preclude the subsequent federal suit and refused to determine whether an express or implied exception to section 1738 applied under the Sherman Act,[129] it felt compelled to launch into a discussion of state preclusion rules. In its discourse, the majority, without citing a single case, suggested that the rule espoused in the Restatement (Second) of Judgments was generally followed, and the Court proceeded to determine the "appropriate" interpretation of the Restatement rule.[130] However, in its generalities, the Court provided few guidelines for the federal district court faced with determining the state preclusion law in a situation as yet unconfronted by most states.[131]

In a well-reasoned concurrence, Chief Justice Burger agreed with the two-step test set forth by the majority, but criticized the majority for its failure to provide guidance to the federal district court. Likewise, the Chief Justice disagreed with the majority's interpretation of the effect and implementation in the antitrust context of the preclusion

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[123]105 S. Ct. at 1333.

[124]*Id.*

[125]726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded*, 105 S. Ct. 1327 (1985).

[126]*Id.* at 1162 (Flaum, J., concurring).

[127]105 S. Ct. at 1334.

[128]*Id.* at 1335.

[129]The Supreme Court in *Kremer* had no difficulty in determining the preclusive effect of the state law judgment under state law, 456 U.S. at 466-67, and determining whether an express or implied repeal of section 1738 was established under Title VII. *Id.* at 468-76. Furthermore, the Supreme Court in *Migra* restated the *Kremer* rule so that the federal issue required resolution first. 104 S. Ct. at 896. After resolving the question of the applicability of section 1738 on claims arising under 42 U.S.C. § 1983 and finding no implied or express repeal thereunder, the court remanded the decision to the district court for resolution of the state preclusion law issue. *Id.* at 899.

[130]105 S. Ct. at 1333.

[131]*Id.*

rule espoused by the majority as that generally accepted by the states.[132]

IV. *Marrese*: More Questions Than Answers

In developing its two-part test regarding the preclusive effect of the state suit, the Supreme Court focused on distinctly different sources at each stage of the test, although relying on the full faith and credit statute as the foundation for each step. First, the Court looked to the original state court judgment.[133] Second, the Court considered the statute underlying the substantive federal claim in the second suit.[134] The Supreme Court's decision to extend its two-step test to areas of exclusive federal jurisdiction[135] such as antitrust was not unreasonable.[136] The Court may be faulted, however, for failing to provide meaningful guidance for lower courts which must apply this test.[137]

A. "Divining" the Effects of State Court Judgments

The Court's first consideration was the original state court judgment. The Court apparently believed that the possible res judicata effect of a judgment, as determined by the law of the state in which the judgment was rendered, was akin to being itself an element of the judgment. Although Congress could statutorily *limit* a state court judgment's preclusive effect as it related to a subsequent federal action, the Supreme Court, citing its 1984 decision in *Migra v. Warren City School District Board of Education*,[138] asserted that federal courts could not give the state judgment preclusive effect beyond that which had originally become a part of that judgment.[139]

Having established that state law should be applied, however, the Supreme Court gave no clear guidance for discerning the state's res judicata law relative to the preclusion of a subsequent federal antitrust

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[132]*Id.* at 1335-37. (Burger, C.J., concurring).

[133]*Id.* at 1332. Section 1738 " 'commands a federal court to accept the rules chosen by the State from which the judgment is taken.' " *Id.* (quoting Kremer v. Chemical Construction Corp., 456 U.S. 461, 481-82 (1982)).

[134]*Id.* at 1333. The second part of the test specifically looks to section 1738 by requiring the court to determine whether the statute underlying the suit provides for an exemption to the full faith and credit statute.

[135]105 S. Ct. at 1334.

[136]The end result of the extension of the *Kremer* analysis to claims within the exclusive jurisdiction of the federal courts is not itself problematic and should eliminate the variety of approaches—although not the differing applications—which the lower courts have adopted in initially applying claim preclusion to antitrust settings. *See supra* text accompanying notes 19-117. However, the majority's superficial analysis and application of earlier cases and their implications does not naturally lead to the conclusion reached by the Court nor does it consider the special concerns of exclusive federal jurisdiction. *See supra* note 121.

[137]*See infra* text accompanying notes 140-41 & 151-52.

[138]104 S. Ct. 892 (1984).

[139]105 S. Ct. at 1334.

suit. While the Court readily acknowledged that "a state court will not have occasion to address the specific question whether a state judgment has issue or claim preclusive effect in a later action that can be brought only in federal court,"[140] the Court nevertheless directed the district court to rely on Illinois' general preclusion principles to determine the effect of an earlier state judgment on the subsequent litigation.[141] Although the Supreme Court declined to determine Illinois' stance regarding the res judicata effect of its state court judgments,[142] in dictum, the Court observed:

> [w]ith respect to matters that were not decided in the state proceedings, we note that claim preclusion generally does not apply where "[t]he plaintiff was unable to rely on a certain theory of the case or to seek a certain remedy because of the limitations on the subject matter jurisdiction of the courts . . . ." Restatement (Second) of Judgments § 26(1)(c) (1982). If state preclusion law includes this requirement of prior jurisdictional competency, which is generally true, a state judgment will *not* have claim preclusive effect on a cause of action within the exclusive jurisdiction of the federal courts.[143]

Although this language clearly is dictum, the Court's use of such broad, unsupported statements is troublesome for several reasons. First, the Court, by characterizing the Restatement provision as one of "jurisdictional competency," strongly suggests that a judgment from a state court in a state where this Restatement provision has been adopted can never preclude an action within the exclusive jurisdiction of the federal courts because the state court lacked jurisdiction to hear the federal claim.[144] This simplistic approach totally ignores the sound reasoning in

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[140]*Id.* at 1332.

[141]*Id.* at 1335. Interestingly, two of the Seventh Circuit judges in *Marrese* had examined the Illinois preclusion law, applied it to the situation confronting the court, and reached opposite conclusions. Judge Cudahy's dissenting opinion recognized a jurisdictional competency requirement in Illinois law which, he concluded, resulted in the non-preclusion of the federal antitrust suit. 726 F.2d 1150, 1177 (7th Cir. 1984)(Cudahy, J., dissenting). However, under Judge Flaum's analysis, examination of Illinois res judicata principles would result in the preclusion of the subsequent federal antitrust suit. *Id.* at 1164 (Flaum, J., concurring and dissenting).

[142]105 S. Ct. at 1335.

[143]*Id.* at 1333. The Restatement (Second) of Judgments provision which the majority opinion cites as the general rule establishes that a claim is not precluded if:

> [t]he plaintiff was unable to rely on a certain theory of the case or to seek a certain remedy or form of relief in the first action because of the limiation on the subject matter jurisdiction of the courts or restrictions on their authority to entertain multiple theories or demands for multiple remedies or forms of relief in a single action. . . .

RESTATEMENT (SECOND) OF JUDGMENTS § 26(1)(c) (1982).

[144]The conclusion reached by the majority opinion is based on the illustration to the Restatement (Second) of Judgments provision:

> A Co. brings an action against B Co. in a state court under a state antitrust law and loses on the merits. It then commences an action in a federal court upon the same facts, charging violations of the federal antitrust laws, of which the federal courts have exclusive jurisdiction. The second action is not barred.

Restatement (Second) of Judgments § 26 at 237, comment c, illustration 2 (1980).

Nash County Board of Education v. Biltmore Company[145] and *Derish v. San Mateo-Burlingame Board of Realtors*[146] in which the courts carefully analyzed the applicable state and federal statutes and determined that, where the two statutes were virtually identical, the plaintiff could not properly assert that he had been "unable to rely on a certain theory" or "to seek a certain remedy." If the state antitrust statute mirrors the federal law, the plaintiff may effectively rely on the same theories or seek the same remedies in state court as he could in federal court. If res judicata principles have any validity, there is no sound reason to suggest that a plaintiff, who has his choice of court systems in which to bring his initial suit, ought to have a second opportunity to relitigate functionally the same claim by suing in federal court.

A second point of concern is that the Supreme Court's assertion that the "jurisdictional competency" requirement embodied in the Restatement has "generally" been adopted by the states is totally unsupported.[147] Interestingly, the Court cites to a Restatement provision as if it were law, while providing not even one citation indicating that *any* state has adopted this provision.[148]

Finally, by suggesting that the Restatement provision represents the law in most states, a district court faced with applying the *Marrese* decision might reasonably assume that the Restatement provision should be applied unless there are clear indications that the state in which the original state judgment was rendered would reach a different result. The high Court made this view plain when it stated, again unsupported by case law, that "[u]nless application of Illinois preclusion law suggests, *contrary to the usual view*, that petitioners' federal antitrust claim is somehow barred, there will be no need to decide in this case if there is an exception to [section] 1738."[149] Clearly it is inappropriate for the Supreme Court to dictate to states what their common law should be and how it should be interpreted by making unsupported statements concerning the "general" or "usual" view of the law.

These problems were recognized and addressed by Chief Justice Burger in his thoughtful concurrence.[150] Although the majority directed the district court to determine whether the second suit would be precluded under Illinois law, the concurrence noted that the majority provided "no guidance . . . as to how the District Court should proceed if it finds state law silent or indeterminate on the claim preclusion question."[151] The majority's "refusal to acknowledge this potential

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[145]640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981); *see supra* notes 55-68 and accompanying text.

[146]724 F.2d 1347 (9th Cir. 1983); *see supra* notes 75-97 and accompanying text.

[147]105 S. Ct. at 1333.

[148]*Id.*

[149]105 S. Ct. at 1333 (italics provided).

[150]*Id.* at 1336-37 (Burger, C.J., concurring).

[151]*Id.* at 1336.

problem appears to stem from a belief that the jurisdictional competency requirement of *res judicata* doctrine will dispose of most cases like this."[152] Even in a state which required jurisdictional competency as an element of res judicata, this requirement might be met constructively even though the federal action was within the exclusive jurisdiction of the federal courts. Such would be the case where "state law provides a cause of action that is virtually identical with the federal statutory cause of action."[153]

Under the majority's interpretation of the "usual view" of state preclusion laws, the similarity of the state and federal antitrust statutes would be irrelevant. Alternatively, a court using the sound reasoning of the concurrence would consider the statutes' similarity as highly significant where the state which rendered the original judgment had not determined the preclusive effect of the state court judgment on a subsequent federal action. Because most states would not have had reason to address the issue of the preclusive effect of a judgment of one jurisdiction relative to a subsequent suit in a different jurisdiction,[154] the concurrence asserted that "it may be consistent with [section] 1738 for a federal court to formulate a federal rule to resolve the matter."[155]

In arguing for a federal rule to be used when the state preclusion law on the issue is not settled, the concurring opinion recognized the competing interests which must be balanced to fashion such a rule.[156] The interests, predictably, are the same ones addressed by the courts in *Nash County Board of Education v. Biltmore Company* and *Derish v. San Mateo-Burlingame Board of Realtors* and by the Seventh Circuit Court of Appeals in *Marrese*: the principles underlying exclusive federal jurisdiction and res judicata.[157] While the concurrence espoused a "full and fair opportunity" test when the "state statute is identical in all material respects with a federal statute within exclusive federal jurisdiction,"[158] the underlying principles of the competing interests may have to be balanced to ascertain when a party has had a "full and fair opportunity" to litigate or when the state and federal statutes are "identical in all respects."

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[152]*Id.*

[153]*Id.*

[154]105 S. Ct. at 1332. *See also id.* at 1336-37 (Burger, C.J., concurring).

[155]*Id.* at 1337 (Burger, C.J., concurring).

[156]The concurrence noted:

> If state law is simply indeterminate, the concerns of comity and federalism underlying [sction] 1738 do not come into play. At the same time, the federal courts have direct interests in ensuring that their resources are used efficiently and not as means of harassing defendants with repetitive lawsuits, as well as in ensuring that parties asserting federal rights have an adequate opportunity to litigate those rights.

Id.

[157]*See supra* notes 5-7 and accompanying text.

[158]105 S. Ct. at 1337 (Burger, C.J., concurring).

Courts faced with balancing these competing interests should be guided by the considerations and analyses of the courts of appeals in *Nash County Board of Education v. Biltmore Company,*[159] *Derish v. San Mateo-Burlingame Board of Realtors*[160] and *Marrese.*[161] In those cases, the courts expressly or impliedly balanced the policies underlying the principles of res judicata and exclusive federal jurisdiction.[162] It is critical that the federal district court analyze and balance these principles when determining state preclusion law in the absence of any law on the subject to determine if the party was given a "full and fair opportunity" to litigate his rights under the federal statute.[163] Although the balancing must be somewhat fact-sensitive, certain factual commonalities in antitrust cases may reveal when one policy will, or should, prevail over the other.

Among the principles underlying res judicata are fairness to the defendant and preservation of judicial resources by "bring[ing] an adjudication to a final conclusion with reasonable promptness and within reasonable limits of cost."[164] Clearly, any time a federal trial follows a similar state action, these policies will be compromised to some extent. Simply conducting the second trial expends judicial resources and costs the parties both time and money. Because the same claims are involved in the two suits where state and federal antitrust and procedural laws are substantially the same, the policies underlying res judicata would be compromised if the second suit were not precluded. Nonetheless, because the second suit will always compromise the policies underlying res judicata, the most significant factors the court should consider in the balance are the policies behind exclusive federal jurisdiction and the extent to which they are affected by the second suit or its preclusion.

Reasons suggested for giving federal courts exclusive jurisdiction over federal antitrust actions include the need for uniform interpretation of federal antitrust law, the expertise of federal judges to handle these suits, and the desire to provide the specified federal remedies and federal procedures relating to the right to a jury trial and liberal discovery provisions.[165] These policies may not always be implicated by applying res judicata to preclude the federal antitrust suit.

Under the reasoning outlined in *Derish*, uniform enforcement of federal antitrust laws would not be implicated if the federal suit were precluded because the state courts' rulings on their own laws would have no precedential effect on the interpretation of federal antitrust laws.[166] If a court precluded the federal suit, however, the federal plaintiff

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[159]640 F.2d 484 (4th Cir.), *cert. denied*, 454 U.S. 878 (1981).

[160]724 F.2d 1347 (9th Cir. 1983).

[161]726 F.2d 1150 (7th Cir. 1984), *rev'd and remanded,* 105 S. Ct. 1327 (1985).

[162]*See supra* text accompanying notes 52-117.

[163]105 S. Ct. at 1337 (Burger, C.J., concurring).

[164]F. JAMES & G. HAZARD, CIVIL PROCEDURE, § 11.2, 530 (2d ed. 1977).

[165]*Derish*, 724 F.2d at 1351-52.

[166]*Id.* at 1351.

would have to settle for the state court's interpretation of state antitrust laws. Even if the state law mirrored the federal law, that particular plaintiff would have been denied the benefit of the uniform enforcement of the federal law. Nevertheless, this inequity would be offset in a situation where the federal plaintiff had brought the state suit as well. There, the plaintiff's action in bringing the state suit first cost him his chance to bring the federal claim.[167] But where the federal plaintiff was the state defendant,[168] the inequity to him would not be offset by the original choice of forum factor. In such a situation, exclusive federal jurisdiction factors would be compromised if the federal suit were precluded.

The argument that the expertise of federal judges is needed in federal antitrust cases carries less weight than it once may have carried because state court judges have increased opportunity to develop expertise in trying antitrust cases. One means by which state judges develop this expertise is when a defendant in a state action asserts a federal antitrust violation as a defense.[169] Also, state judges try state antitrust cases involving laws similar to the federal statutes.[170] Therefore, this policy behind exclusive jurisdiction will seldom provide a strong reason not to apply res judicata in the second action.

If state and federal antitrust and procedural laws are materially identical or similar, the exclusive federal jurisdiction policy of providing the benefits of substantive and procedural laws would not be compromised by applying res judicata. The boundaries outlining how closely the state statute must mirror the federal law have not yet been drawn. While the concurrence encouraged the adoption of a "similarity" standard of "identical in all material respects," this standard still would leave open questions regarding the "materiality" of any variations between the state and federal antitrust statutes. The three appellate courts addressing this issue, faced with state statutes which were progressively more dissimilar to the federal antitrust law, each determined that the appropriate similarity standard was met. In *Nash*, for example, the state statute was identical to the federal law except for the federal requirement of interstate commerce, which was not present in the state law.[171] The California law considered in *Derish*, although apparently not identical to the federal statute, was "similar"

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[167]*See, e.g.*, Straus v. American Publishers' Ass'n, 201 F. 306 (2d Cir. 1912).

[168]*See, e.g.*, Lyons v. Westinghouse Electric Corp., 222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955).

[169]*See* Currie, *Res Judicata: The Neglected Defense*, 45 U. CHI. L. REV. 317, 347 (1978).

[170]*Derish*, 724 F.2d at 1351-52.

[171]*Nash*, 640 F.2d at 488.

Similarly, Indiana's antitrust law, IND. CODE §§ 24-1-2-1 to -2-12 (1982), has been patterned after the Sherman Antitrust Act, 15 U.S.C. §§ 1-7 (1982), and courts are admonished to look to the federal law in construing Indiana's statute. *See* Orion's Belt, Inc. v. Kayser-Roth Corp., 433 F. Supp. 301 (S.D. Ind. 1977).

to the Sherman Act, and both laws provided the same rights.[172] In *Marrese*, however, the circuit court had said the federal and state statutes only had to be equivalent "not in gross but with reference to the specific provisions of the state and federal statutes, read in light of the specific allegations of the complaint."[173] This expansive language opens the door to very liberal rulings precluding federal antitrust suits. The mischief which can be achieved by this approach was amply illustrated in *Marrese*. There, although the state and federal damage provisions were different, the court said this difference was insignificant because the plaintiffs really were not interested in collecting damages.[174] This questionable reasoning should not be extended. Nonetheless, the "equivalency" or "nonequivalency" of the state and federal antitrust laws, especially in terms of remedies, represents a significant factor which should tilt the balance in favor of res judicata or exclusive federal jurisdiction, although the court may construe the statutes broadly or focus only on certain "pertinent" portions to support the desired policy and decision.

In almost every situation involving a second suit, the policies supporting res judicata—fairness to the defendant and preservation of judicial resources—will be implicated to some extent. On the other hand, the policies behind exclusive federal jurisdiction—uniform interpretation of federal laws and the protection of federal remedies and procedures—may tilt the balance in favor of allowing the second suit in instances where the state and federal antitrust statutes are not truly "identical in all material respects" or where the federal plaintiff was the defendant in the prior suit.

Although the balancing of the competing interests involved in determining whether a party has had a "full and fair opportunity" to litigate his rights under the federal antitrust statute does not provide a concrete standard, it does provide needed guidance to the courts confronted with the difficult task of determining the first step mandated by the Supreme Court in *Marrese*.

B. The Full Faith and Credit Exception: A Decision for Another Day

The second part of the Supreme Court's test is directed toward the statute underlying the federal action. The courts must now decide whether actions brought under the federal antitrust laws are to be excepted from the requirements of section 1738.

At this stage in the analysis, section 1738 will bar federal suits filed subsequent to litigation in state courts concerning the same operative facts unless a court finds an exception to the Full Faith and Credit

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[172]*Derish*, 724 F.2d at 1350.

[173]*Marrese*, 726 F.2d at 1155.

[174]*Id.* at 1156.

Statute in the federal statute.[175] Quoting its 1982 decision in *Kremer v. Chemical Construction Corporation*, the Supreme Court stated in *Marrese* that " 'an exception to [section] 1738 will not be recognized unless a later statute contains an express or implied repeal.' "[176] In determining whether such an exception exists, the court should look to "the particular federal statute as well as the nature of the claim or issue involved in the subsequent federal action."[177] However, in the final analysis, "the primary consideration must be the intent of Congress."[178]

The Supreme Court refused to determine whether Illinois state law precluded Dr. Marrese's federal antitrust claim,[179] and therefore decided that it did not have to reach the issue whether the Sherman Antitrust Act precluded the subsequent suit because if Illinois law would permit the second suit, the existence of an exception to section 1738 would be irrelevant because the inquiry would end at that point and the suit would be permitted. The court's failure to determine the state law issue, however, need not have ended its inquiry. Where state law would preclude the subsequent suit, the determination of whether an exception to section 1738 exists determines whether the federal antitrust suit will be allowed. Further, although the Supreme Court made clear in *Marrese* that state law must be applied *first*,[180] where there is an exception to section 1738, the second suit will always be permitted, regardless of state law.

The order of the two steps makes no difference in the result. If the section 1738 determination were made before the state law decision, the court would simply allow the second suit if an exception to section 1738 existed and would look to state law to decide the issue if no section 1738 exception applied. Regardless of the order in which the steps are taken, the second suit would be precluded only if *both* the state law and section 1738 determinations would preclude the second suit; if it would be permitted under *either* step of the test, the second suit would be allowed.

The Supreme Court's failure to address the section 1738 exception question raises the possibility that the district court, on remand, will do its best to apply Illinois law to determine whether the second *Marrese* suit is precluded, only to discover that this determination was irrelevant because the Sherman Act provides an implied exception to section 1738,

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[175]Marrese v. American Academy of Orthopaedic Surgeons, 105 S. Ct. 1327 (1985). *See also supra* notes 122-124 and accompanying text.

[176]105 S. Ct. at 1332 (quoting Kremer v. Chemical Construction Corp., 456 U.S. 461, 468 (1982)). For a discussion of *Kremer*, see *supra* note 119.

[177]105 S. Ct. at 1335.

[178]*Id.*

[179]The refusal of the Supreme Court in *Marrese* to decide whether state law precluded the second suit is in sharp contrast with the Court's *Kremer* decision in which it apparently felt no reluctance to determine the preclusive effect of the appropriate state law. *See supra* note 120.

[180]105 S. Ct. at 1335.

thus permitting the second suit regardless of Illinois res judicata law.[181]

IV. Conclusion

The Supreme Court's decision in *Marrese v. American Academy of Orthopaedic Surgeons* provided an opportunity for the Court to enunciate definitively the approach which the lower courts should use to determine when to preclude a federal antitrust suit following a state court judgment and, more generally, when the courts should preclude exclusive federal jurisdiction actions. Although the Supreme Court outlined a two-part test in *Marrese*, its remand of the case to the district court with little meaningful guidance regarding the test's application virtually ensures that the courts, applying the two-part test as they deem appropriate, will continue to take varying approaches, and reach differing results, in making these res judicata determinations.

Where state law is unclear, a court deciding whether state law precludes a subsequent federal antitrust suit would be well-advised to consider the factors balanced by the courts of appeals in *Nash County Board of Education v. Biltmore Company*, *Derish v. San Mateo-Burlingame Board of Realtors*, and *Marrese* and implicitly approved in the "full and fair opportunity" to litigate standard set out in Chief Justice Burger's *Marrese* concurrence. These considerations provide a sounder and more realistic basis for approaching the res judicata question in the exclusive federal jurisdiction context than do the simplistic generalities described by the majority in the Supreme Court's *Marrese* decision. Fortunately, the majority's generalities were mere dictum; by taking a more considered approach to applying the two-part test than was implied by the Supreme Court, courts may yet fulfill the high Court's mandate while still considering the important policies underlying res judicata and exclusive federal jurisdiction to yield fair, equitable, and well-reasoned preclusion decisions.

Mark A. Bailey

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[181]This possible result would be avoided if the Court were to follow the method it used to apply the two-part test in Migra v. Warren City School District Board of Education, 104 S. Ct. 892 (1984). There the Supreme Court looked *first* to whether a section 1738 exception applied; finding none, the Court then looked to whether state law would preclude the second suit.

Judicial Review of Shareholder Derivative Suits: Directors' Diminishing Control of Corporate Litigation

I. Introduction

When the two top officers of Financial Corporation of America resigned under pressure during a severe liquidity crisis at the company,[1] they were reportedly paid severance settlements totalling $3,000,000. One month later, a shareholder filed a derivative lawsuit[2] seeking the return of the money to the corporation and alleging that the payments were a waste of corporate assets.[3] The defendants undoubtedly will raise the business judgment rule[4] as a defense by arguing that the decision to make the payments was a good faith business decision and consequently not subject to judicial review.

This case is typical of the increasing use of the shareholder derivative suit as a means for shareholders to make the officers and directors of a corporation accountable for misconduct in the management of corporate affairs. The business judgment rule traditionally has protected corporate directors from liability when business decisions have been made in good faith and in the absence of any breach of the directors' fiduciary duty to the corporation.[5] However, recent court decisions have eroded the protections of the business judgment rule as a defense in derivative litigation.[6] On one side of the controversy are those who believe that the increased use of derivative suits and the corresponding decline of the business judgment rule represent a long overdue check on management activities such as those reported in the Financial Corporation of America case. Others argue that the increased accountability of directors paralyzes boards of directors by making them unwilling to take legitimate risks in managing the corporation for fear of being held personally liable for the consequences.[7]

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[1] *Financial Corp. of America is Sued Over Severance Outlay*, Wall St. J., Sept. 28, 1984, at 2, col. 4.

[2] *See infra* text accompanying notes 18-38.

[3] Wall St. J., Sept. 28, 1984, at 2, col. 4.

[4] *See infra* text accompanying notes 54-64.

[5] United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Briggs v. Spaulding, 141 U.S. 132 (1891).

[6] *E.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982); Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). Many cases have upheld the business judgment rule. *E.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

[7] *See Business-Judgment Rule Draws Criticism As More Firms Take Anti-Takeover Steps*, Wall St. J., Aug. 10, 1984, at 21, col. 4.

Several articles[8] have discussed the business judgment rule, derivative actions, and the demand requirement.[9] This area of law received considerable attention after the landmark decision in *Zapata Corp. v. Maldonado*[10] created a higher level of judicial scrutiny of motions to dismiss excused demand derivative suits.[11] Nevertheless, an assessment of recent developments is appropriate, particularly after a recent Delaware decision which elaborates on the *Zapata* ruling and defines the limits of the demand requirement.[12]

This Note will analyze recent developments in two aspects of shareholder derivative suits: the demand requirement and corporations' motions to dismiss these suits. This Note will provide an overview of the shareholder derivative suit,[13] the development of the special litigation committee,[14] and the business judgment rule.[15] Additionally, the methods used by courts to evaluate the demand requirement and dismissal motions will be examined.[16] The conclusion will suggest a standard for evaluating both the demand issue and dismissal motions that promotes the interests of the shareholders while preserving the essence of the business judgment rule.[17]

II. Background

A. Shareholder Derivative Actions

Shareholders may initiate a suit to enforce a right that the corporation could have asserted directly but has failed to pursue.[18] The derivative

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[8]Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule*: Zapata *One Year Later*, 38 Bus. Law. 401 (1983); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw.U.L. Rev. 96 (1980); Stellingwerf, *Involuntary Dismissals of Shareholder's Derivative Suits*, 10 Sec. Reg. L.J. 246 (1982); Note, *The Business Judgment Rule and the Litigation Committee: The End of a Clear Trend in Corporate Law*, 14 Ind. L. Rev. 617 (1981); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168 (1976); Comment, *Limits On The Power of Directors To Terminate Shareholder Litigation: The Revival of The Derivative Suit*, 50 U. Cin. L. Rev. 786 (1981); Comment, Zapata Corp. v. Maldonado: *Restricting the Power of Special Litigation Committees to Terminate Derivative Suits*, 68 Va. L. Rev. 1197 (1982); Comment, *Directors' Business Judgment In Terminating Derivative Suits Subject To Judicial Review*, 59 Wash. U.L.Q. 1425 (1982).

[9]A shareholder, before filing a derivative action, must make a demand on the board of directors that the board pursue the claim on behalf of the corporation. *See infra* text accompanying notes 25-33.

[10]430 A.2d 779 (Del. 1981).

[11]*See infra* text accompanying notes 27-29.

[12]Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[13]*See infra* notes 18-38 and accompanying text.

[14]*See infra* notes 39-53 and accompanying text.

[15]*See infra* notes 54-64 and accompanying text.

[16]*See infra* notes 65-196 and accompanying text.

[17]*See infra* notes 202-211 and accompanying text.

[18]8 Federal Procedural Forms § 22:5 (L. Ed. 1976). The complaint must contain specific allegations, including the basis for the claims, the status of the shareholder at

action is a procedural device under which the substantive right of action arises from state law.[19] The plantiff shareholder is a nominal plantiff; the real party in interest is the corporation.[20] Typical defendants include other shareholders, directors and officers of the corporation, and third parties from whom relief is sought.[21] The corporation, as a necessary and indispensable party, is also joined as a defendant.[22]

In a derivative suit, the complaint should allege that the transaction was beyond the board's authority, that the action was fraudulent and resulted in severe detriment to the corporation, or that a majority of shareholders was illegally acting in the name of the corporation in violation of the rights of the other shareholders.[23] A derivative suit alleges a breach of duty to the corporation and seeks to compel the directors to pursue the claim for the benefit of the corporation. As such, the derivative suit is distinct from an individual shareholder's action against the corporation for a breach of the shareholder's membership contract with the corporation.[24]

Before filing a derivative action, the shareholder must make a demand on the board to pursue the claim for the benefit of the corporation.[25] This procedure gives the corporation the opportunity to enforce the claim or remedy the alleged wrongdoing on its own and to avoid the involvement of the courts.[26] The demand may be excused if the complaining shareholder can demonstrate that demand would be futile[27] because of the directors' adverse interests or their participation in the alleged wrong-

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the time of the questioned action, the efforts made by the plaintiffs to obtain the desired action from the directors, the reasons for the failure to obtain that action or the reasons why no demand was made, and the adequacy of the plaintiff's representation of the interests of the shareholders. *Id.* § 22:14. The plaintiff must fairly and adequately represent the interests of shareholders similarly situated, although the defendant bears the burden of proving inadequate representation. *Id.* § 22:7.

Before a derivative action may be dismissed or compromised, the parties must obtain approval from the court. *Id.* § 22:12. The shareholders must receive notice of the proposed compromise or dismissal. *Id.* If there is no fraud or collusion, a settlement of a derivative action has the res judicata effect of a final judgment. *Id.*

[19]*Id.* § 22:13.

[20]*Id.* § 22:9.

[21]18 C.J.S. CORPORATIONS § 570 (1939).

[22]*Id.*

[23]Hawes v. Oakland, 104 U.S. 450, 460 (1881).

[24]H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 360, at 755-61 (2d ed. 1970). The membership contract refers to the rights and duties that define the shareholder's relationship with the corporation. Examples of actions for breach of a membership contract include compelling payment of dividends and enforcing the right to examine the corporate books. *Id.* at 757.

[25]FED. R. CIV. P. 23.1 provides in part: "[T]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff, to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort."

[26]Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171 (1976).

[27]FED. R. CIV. P. 23.1.

doing.[28] The shareholder has the burden of showing why demand would be pointless and must allege these facts with particularity.[29] The court addresses the demand issue when the corporation, in response to the plaintiff shareholder's complaint, moves for dismissal for failure to make the requisite demand on the board of directors.[30]

The board may refuse a demand to pursue a claim if it determines that pursuit of the action would not be in the corporation's best interests.[31] In this way the directors can dispose of strike suits, meritless litigation, or even valid claims that would cost the corporation more to pursue than could be recovered.[32]

After the refusal of a demand or if a demand is excused, the shareholder may file the derivative suit. The board of directors then decides whether or not to pursue the claim and assume control of the litigation. If it is determined that continuing the litigation would not be in the corporation's best interests, the directors will move for dismissal.[33]

A collateral issue in shareholder derivative suits concerns the choice of law in a particular case. Many derivative actions are brought in federal courts because the claims arise under federal securities law. The United States Supreme Court has ruled that state law will govern the disposition of a derivative suit even if the cause of action is based on a federal statute.[34] If state law permits disinterested directors to terminate a suit, the court must inquire whether such state law is consistent with the policies inherent in the federal statutes.[35] Likewise, state law controls in diversity suits in federal courts.[36] Because of the prevalence of Delaware incorporation, Delaware law governs many of these derivative actions.[37]

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[28]Stepak v. Dean, 434 A.2d 388, 390 (Del. Ch. 1981) (citing Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277, 281-82 (1927)). *See also* Rogers v. Lafayette Agricultural Works, 52 Ind. 296 (1875); Cole Real Estate Corp. v. Peoples Bank & Trust Co., 160 Ind. App. 88, 310 N.E.2d 275 (1974); Marcovich v. O'Brien, 63 Ind. App. 101, 114 N.E. 100 (1916).

[29]Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); *In re* Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

[30]18 C.J.S Corporations § 575 (1939).

[31]Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

[32]*Id.*

[33]Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980). *See also* Gaines v. Haughton, 645 F.2d 761, 772 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Lewis v. Anderson, 615 F.2d 778, 782 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

[34]Burks v. Lasker, 441 U.S. 471, 478-79 (1979).

[35]*Id.* at 479.

[36]Swanson v. Traer, 354 U.S. 114, 116 (1957).

[37]Cases in many jurisdictions have been governed by Delaware law. *E.g.*, Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983); Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983); *In re* Continental Illinois Securities Litigation, 572 F. Supp. 928 (N.D. Ill. 1983); Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982); Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y.

Delaware law is also quite influential in those cases where another state's law applies when that state's law is relatively undeveloped in the area.[38]

B. The Special Litigation Committee

When members of the board of directors are implicated in a challenged activity or named as defendants in a suit, the board may appoint a special litigation committee (SLC) and grant it the authority to investigate the allegations and decide whether or not to continue the litigation.[39] A tainted board may delegate its authority over the litigation to a committee of disinterested directors.[40] Usually the SLC consists of outside directors appointed to the board since the alleged wrongdoing.[41] The SLC typically hires outside legal counsel to conduct an investigation of the claims.[42] The SLC then produces a report of its findings and recommends whether or not to pursue the litigation.[43]

The board of directors frequently delegates to the SLC the power to move for dismissal of the action if the committee determines that the proposed suit is not in the corporation's best interests.[44] Among the

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1980).

The Delaware state courts have heard many of the important cases in this area of law. *E.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Abbey v. Computer & Communications Technology Corp., 457 A.2d 368 (Del. Ch. 1983); Bergstein v. Texas Int'l, Co., 453 A.2d 467 (Del. Ch. 1982); Stepak v. Dean, 434 A.2d 388 (Del. Ch. 1981); Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (1927).

[38]*E.g.*, Hasan v. CleveTrust Realty Investors, 729 F.2d 372 (6th Cir. 1984) (Massachusetts law); Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983) (Connecticut law); Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) (California law); Watts v. Des Moines Register and Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981) (Iowa law).

[39]Lewis v. Anderson, 615 F.2d 778, 782-83 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981).

[40]430 A.2d at 786.

[41]*E.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Mills v. Esmark, Inc., 91 F.R.D. 70 (N.D. Ill. 1981); Zapata Corp. v. Maldonado, 430 A.2d at 781.

[42]*E.g.*, Gaines v. Haughton, 645 F.2d 761, 768-69 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Mills v. Esmark, Inc., 91 F.R.D. 70, 71-72 (N.D. Ill. 1981).

[43]A typical special litigation committee (SLC) report contains an extensive factual review of the allegations, includes witness interviews, and an examination of corporate records. The report evaluates the merits of the claims and the probable costs and benefits of continuing the litigation. *See generally* Gaines v. Haughton, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983).

[44]*See, e.g.*, Gaines v. Haughton, 645 F.2d 761, 770-71 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Zapata Corp. v. Maldonado, 430 A.2d at 785. *But see* Hasan v. CleveTrust Realty Investors, 729 F.2d 372 (6th Cir. 1984); Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983) (SLC in both cases recommended that the board move for dismissal).

reasons given for not pursuing a claim are that such a suit would not be in the shareholders' best interests,[45] that the claim is not in the corporation's best interests,[46] that "legal action against the defendants could significantly impair their ability to manage corporate affairs,"[47] that pursuit of the claims would have an adverse effect on morale and impose heavy costs on the corporation,[48] and that there was little chance of success on the merits.[49] Occasionally, the SLC will decide to proceed with the shareholder's claims.[50]

Finally, the court decides whether or not to grant the motion to dismiss after examining the good faith and autonomy of the SLC and the thoroughness of its investigation.[51] In the past, the business judgment rule precluded the courts from reviewing the merits of a decision reached by an independent board or SLC.[52] Nonetheless, recent developments in the law have eroded this rule.[53]

C. The Business Judgment Rule

The business judgment rule developed as a means of limiting the liability of a corporation's officers and directors for mistakes made while performing their corporate responsibilities. As early as 1855, directors were not held accountable unless guilty of misconduct amounting to a breach of trust or fraud on the corporation,[54] but members of the board of directors were expected to exercise the standard of care of ordinary,

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[45]Gaines v. Haughton, 645 F.2d 761, 768 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981).

[46]Zapata Corp. v. Maldonado, 430 A.2d at 781.

[47]Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979).

[48]Mills v. Esmark, Inc., 573 F. Supp. 169, 172 n.2 (N.D. Ill. 1983).

[49]Joy v. North, 692 F.2d 880, 884 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); Mills v. Esmark, Inc., 573 F. Supp. 169, 172 n.2 (N.D. Ill. 1983).

[50]Seafirst Corporation appointed an SLC to investigate shareholders' claims stemming from losses incurred in the company's energy loan portfolio. After an investigation, the SLC decided to pursue the litigation against some former officers and the corporation's outside auditors after finding that there were "viable claims." *BankAmerica's Seafirst Unit to Pursue Claims Against Former Head, Audit Firm*, Wall St. J., Aug. 21, 1984, at 4, col. 2.

[51]*E.g.*, Gaines v. Haughton, 645 F.2d 761, 772 (9th Cir.), *cert. denied*, 454 U.S 1145 (1981); Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 623-24, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979). As these cases demonstrate, courts consider an SLC independent if its members were appointed to the board after the alleged wrongdoing occurred and if the SLC members do not have business or personal connections with the implicated directors. *See also* Hasan v. CleveTrust Realty Investors, 729 F.2d 372 (6th Cir. 1984).

[52]United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724, 729 (8th Cir. 1979); Auerbach v. Bennett, 47 N.Y.2d 619, 623, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979).

[53]*See infra* text accompanying notes 137-196.

[54]Briggs v. Spaulding, 141 U.S. 132, 149 (1890); Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855).

prudent, and diligent men.[55] In 1917, Justice Brandeis explained the scope of the business judgment rule: "Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, where they stand in a dual relation which prevents an unprejudicied exercise of judgment . . . ."[56] Therefore, absent serious wrongdoing, the directors could operate without fear of personal liability.

The justifications for the rule include the need for corporations to attract qualified individuals as directors and the desire to promote judicial and business economy.[57] If directors were subjected to personal liability for mistakes of judgment or for the ordinary fluctuations of business conditions, corporations would be unable to retain competent directors. The rule promotes judicial ecomomy by giving corporations the latitude to settle most disputes without court involvement. Business economy is likewise promoted because most business decisions and disputes are handled expeditiously by internal corporate mechanisms, such as voting unsatisfactory directors out of office and exerting pressure on the directors through shareholder meetings and proxy votes. Furthermore, the rule defers to the directors' expertise at managing a business enterprise.[58]

Courts still adhere to the idea of the business judgment rule.[59] A recent Delaware decision characterized the rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[60] The decision of a board of directors will not be disturbed if the court can find a rational business purpose behind the action.[61] Anyone challenging the presumption that directors have used their best business judgment has the burden of production of evidence to the contrary.[62]

Application of the business judgment rule occurs frequently in derivative suits in which shareholders challenge the corporation's business

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[55]Briggs v. Spaulding, 141 U.S. 132, 152 (1890).

[56]United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917).

[57]Comment, *Limits On The Power of Directors To Terminate Shareholder Litigation: The Revival of The Derivative Suit*, 50 U. Cin. L. Rev. 786, 787-88 (1981).

[58]Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).

[59]*E.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir.), *cert. denied*, 454 U.S. 1145 (1981); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

[60]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

[61]Whittaker Corp. v. Edgar, 535 F. Supp. 933, 950 (N.D. Ill. 1982) (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

[62]Panter v. Marshall Field & Co., 646 F.2d 271, 296 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

decisions.[63] However, where the corporate charter has delegated the authority to manage the corporation to directors, the shareholders have no right to challenge the board's judgment absent a showing of bad faith.[64] In other words, shareholders may not sue their directors merely because of a disagreement over the management of the company; there must be a showing of actual wrongdoing or a breach of trust in order to initiate litigation.

III. The Demand Requirement: A Lower Threshold for Initiating Litigation

A. Background

A shareholder seeking to institute a derivative action must first make a demand on the corporation. This demand is an essential preliminary step in any derivative action. If the complainant fails to demand that the corporation enforce the claim or fails to prove that demand would be futile, the court will dismiss the suit.[65] The criteria courts use to ascertain whether or not demand should be excused have become increasingly important after the *Zapata Corp. v. Maldonado*[66] ruling which introduced a higher degree of judicial scrutiny of dismissal motions made by a special litigation committee in demand excused cases.[67]

The demand requirement originated as a means to avoid abuses of shareholder derivative suits and to prevent court intervention in the dispute until all intracorporate remedies have been exhausted.[68] Deference to the directors' decision allows prompt termination of meritless suits and elimination of unnecessary litigation expenses.[69] The demand requirement also affords corporations a procedure for disposing of suits brought to harass the company or to extract a favorable settlement for the named plaintiff or his attorney rather than to correct wrongs to the

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[63]In contrast to its application in derivative suits, the business judgment rule is criticized when used as a defense to charges of securities law violations during hostile takeover battles. In this instance, the Securities and Exchange Commission (SEC) or investors may sue the corporation on their own behalves. The drastic defenses used by corporations against these takeover attempts often incite allegations that the officers and directors were acting to further their own interests rather than to promote the best interests of the corporation. There has been a growing concern in both Congress and the courts that the business judgment defense should be used in takeover situations only when the directors were acting objectively and fairly on behalf of the corporation. *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 (2d Cir. 1984); H.R. Rep. No. 1028, 98th Cong., 2d Sess. 14-15 (1984).

[64]Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341 (1855).

[65]Fed. R. Civ. P. 23.1.

[66]430 A.2d 779 (Del. 1981).

[67]*See infra* text accompanying notes 136-46.

[68]Comment, *supra* note 26, at 168-71.

[69]Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

corporation.[70] Moreover, where litigation is appropriate, the corporation is frequently in a better position to bring the suit because of its familiarity with the activity at issue and its greater financial resources.[71]

In many of the early cases in which the demand requirement was discussed, the primary rationale for excusing demand was that the procedure would be futile. The First Circuit Court of Appeals in *In re Kauffman Mutual Fund Actions*[72] concluded that there must be specific allegations that the board was under the control and domination of the wrongdoers.[73] The fact that the named defendants were directors who participated in the challenged transaction was not sufficient to excuse demand.[74] This ruling created a substantial burden for plaintiffs seeking to prove that demand was unavailing.

In contrast, the Seventh Circuit Court of Appeals in *Nussbacher v. Continental Illinois National Bank & Trust Co.*,[75] in a situation similar to that in *Kauffman*, found that where the majority of outside directors approved of or participated in the alleged misconduct, demand would be excused.[76] Examination of allegations of futility focused on the extent to which members of the board of directors were implicated in the purported misconduct. If the complaint showed a genuine conflict of interest between the board's corporate responsibilities and board members' potential personal liability for wrongdoing, the demand requirement was waived.[77]

Other cases illustrate how courts have analyzed the particular facts of the case and balanced concerns over conflicts of interest and domination of the board by the defendants against the right of the corporation to control the litigation. In *Cramer v. General Telephone & Electronics Corp.*,[78] the court, declining to excuse demand, decided that although four of the fourteen individuals on the board were defendants, there was no evidence that the remaining directors were involved in the allegedly fraudulent activity or under the control of the defendants.[79] Conversely, the fact that the complaint concerned a long course of conduct involving decisions made by the entire board, all but one of whom were named as defendants, persuaded the court in *Zilker v. Klein*[80] to excuse demand.

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[70]Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

[71]Lewis v. Graves, 701 F.2d 245, 248 (2d Cir. 1983).

[72]479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

[73]479 F.2d at 264.

[74]*Id.*

[75]518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976).

[76]518 F.2d at 879.

[77]Comment, *supra* note 26, at 174-75.

[78]582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

[79]582 F.2d at 276-77.

[80]510 F. Supp. 1070 (N.D. Ill. 1981).

B. Recent Trends—Increasing Judicial Scrutiny of the Demand Requirement

After the landmark *Zapata* decision in 1981,[81] courts began to place greater emphasis on the demand requirement and the standards used for ascertaining whether or not demand was futile. In *Lewis v. Graves*,[82] all of the directors were named in a derivative action alleging various violations of securities laws in connection with J. Ray McDermott & Co.'s acquisition of the Babcock and Wilcox Company and the issuance of McDermott stock to certain McDermott officers and directors. No demand was made prior to the filing of the complaint. The complaint maintained that demand was futile because all of the directors had "knowingly participated, assisted, aided and abetted in the wrongful acts."[83] The court reasoned that demand is futile when the directors are antagonistic or involved in the disputed transactions but upheld the district court's determination that, absent specific charges of bias or of self-dealing by the majority of the directors, demand was required.[84] Lacking sufficiently specific charges, the *Graves* court refused to excuse demand:

> The fact that a corporation's directors have previously approved transactions subsequently challenged in a derivative suit does not inevitably lead to the conclusion that those directors, bound by their fiduciary obligations to the corporation, will refuse to take up the suit. . . . Rule 23.1 would be substantially diluted if prior board approval standing alone established futility. . . . Excusing demand on the mere basis of prior board acquiescence, therefore, would obviate the need for demand in practically every case.[85]

The *Graves* court also expressed the concern that by merely naming all the directors as defendants the plaintiffs could circumvent the demand requirement.[86] The conclusion here represents a continuation of the relatively strict standard for excusing demand espoused by the *Kauffman* case.

Another group of cases illustrates the evaluation of the futility of demand by focusing on the percentage of the board that is implicated by the charges.[87] In *Abramowitz v. Posner*,[88] the Second Circuit Court of Appeals, applying Delaware law, decided that demand was not

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[81] *See infra* text accompanying notes 137-47.

[82] 701 F.2d 245 (2d Cir. 1983).

[83] *Id.* at 247 (quoting the complaint).

[84] *Id.* at 248.

[85] *Id.* (citation omitted). *Accord* Kaster v. Modification Sys., Inc., 1983 FED. SEC. L. REP. (CCH) ¶ 99,184 (S.D.N.Y. April 26, 1983).

[86] 701 F.2d at 249.

[87] *See* Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982); Lewis v. Curtis, 671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); Vanderbilt v. Geo-Energy Ltd., 590 F. Supp. 999 (E.D. Pa. 1984); Abbey v. Computer & Communications Technology Corp., 457 A.2d 368 (Del. Ch. 1983).

[88] 672 F.2d 1025, 1033 (2d Cir. 1982).

necessarily futile when five of the seventeen directors were named as defendants and those five had cooperated in a related SEC investigation. Furthermore, there was no evidence that a litigation committee's investigation into the charges was not conducted fairly and independently.[89]

Conversely, courts have decided that demand was futile if a majority of the board was involved in the disputed activity.[90] These decisions tend to probe the realities of the particular situation to determine whether or not demand would be a meaningless formality. If a demand on the board of directors is unlikely to produce any action to enforce the corporation's claim, the requirement will be waived.[91] For instance, where the claims involved self-dealing in the corporation's assets among the corporation's board and its two parent corporations and where the majority of the directors were also officers or board members of those parent companies, the court concluded that requiring demand would accomplish nothing except to delay the plaintiff shareholder's suit.[92]

A recent Delaware case, *Abbey v. Computer & Communications Technology Corp.*,[93] illustrates this pragmatic approach to the demand requirement. The plaintiff shareholder filed the derivative suit shortly after making a demand on the directors. The board appointed a special litigation committee to investigate the charges. In ruling on the demand issue, the court held that the aggrieved shareholder must give the board a reasonable opportunity to respond to the demand before claiming that the demand was unavailing.[94] However, the court further declared that the board of directors, by appointing a litigation committee with binding authority to decide whether or not to pursue the action, had, in effect, admitted that the shareholder was justified in initiating the suit without demand.[95] By deciding to appoint a litigation committee to investigate the claims, the board conceded that it was not qualified to pursue the claims for the corporation.[96] Therefore, the shareholder could reasonably be excused from making a demand.[97] This case not only illustrates judicial willingness to excuse demand, but also demonstrates the unpredictable effects of any corporate response to a derivative suit. By appointing a

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[89]*Id.* at 1034.

[90]Lewis v. Curtis, 671 F.2d 779, 784 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); Vanderbilt v. Geo-Energy Ltd., 590 F. Supp. 999 (E.D. Pa. 1984); Bergstein v. Texas Int'l Corp., 453 A.2d 467, 470-71 (Del. Ch. 1982) (citing Dann v. Chrysler Corp., 174 A.2d 696 (Del. Ch. 1961)). *See also* Stepak v. Dean, 434 A.2d 388 (Del. Ch. 1981)(where a majority of directors were not named in the suit, demand was not excused on the theory directors would be asked to sue themselves).

[91]Lewis v. Curtis, 671 F.2d 779, 786 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982).

[92]Vanderbilt v. Geo-Energy Ltd., 590 F. Supp. 999 (E.D. Pa. 1984).

[93]457 A.2d 368 (Del. Ch. 1983).

[94]*Id.* at 371. *See also* Smachlo v. Birkelo, 576 F. Supp. 1439 (D. Del. 1983) (Plaintiff must make a serious demand that the corporation pursue the claim and allow a reasonable time for response before filing suit.).

[95]457 A.2d 368, 372-73.

[96]*Id.*

[97]*Id.*

litigation committee in an attempt to frame an appropriate response to the demand, the board found itself, in effect, admitting that the shareholder was justified in omitting the demand.

A federal district court in Illinois provided another rationale for excusing demand. In *Mills v. Esmark, Inc.*,[98] the plaintiffs made a demand on the board but filed suit before the directors responded. The court dismissed the complaint and held that a dissident shareholder must make a sincere effort to obtain cooperation from the corporation before filing suit.[99] Through a litigation committee, the directors then proceeded to investigate the claims and concluded that continuation of the action was not in the corporation's best interests. The plaintiffs meanwhile filed an amended complaint which reasserted old claims and added new ones.[100] The court at that point excused demand because the directors had expressed their opposition to the litigation after the first investigation, even though there was no intimation that the board had acted in bad faith.[101] Because another demand would only prolong the dispute, the court excused demand as a waste of time.[102]

This fact-dependent approach enables courts to excuse demand more readily than under the rule that requires specific allegations of wrongdoing by the board. Furthermore, by excusing demand more frequently, these courts have been able to apply the closer degree of scrutiny to motions to dismiss derivative suits that the *Zapata* decision permits for demand excused cases.[103]

C. Aronson v. Lewis - *Delaware's Guidelines For Excusing Demand*

These developments, while permitting courts to exercise their own discretion in enforcing the demand requirement, establish no guidelines either for the parties to the litigation or for the courts to follow in determining whether or not demand is superfluous.[104] The Delaware Supreme Court recently issued an opinion creating a test for assessing the futility of requiring demand.[105] In this case, the court accepted an interlocutory appeal from the Court of Chancery's ruling that excused demand and denied the defendant's dismissal motion. The lower court had found that the plaintiff's allegations raised a reasonable inference

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[98]91 F.R.D. 70 (N.D. Ill. 1981).

[99]*Id.* at 73.

[100]Mills v. Esmark, Inc., 573 F. Supp. 169, 172 (N.D. Ill. 1983).

[101]*Id.* at 172 (citing Mills v. Esmark, Inc., 544 F. Supp. 1275 (N.D. Ill. 1982)).

[102]Mills v. Esmark, Inc., 573 F. Supp. 169, 172 (N.D. Ill. 1983).

[103]*E.g.*, Lewis v. Curtis, 671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983); Abbey v. Computer & Communications Corp., 457 A.2d 368 (Del. Ch. 1983).

[104]*See* Bergstein v. Texas Int'l Corp., 453 A.2d 467, 470 (Del. Ch. 1982) (discussing the fact that the Delaware Supreme Court had not offered any guidelines for evaluating the demand requirement).

[105]Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

that the directors' actions were not protected by the business judgment rule.[106] The dispute arose over an employment agreement with a director who owned forty-seven percent of the corporation's stock. The complaint alleged that the agreement had no valid business purpose and was a waste of corporate assets. In addition, the complaint maintained that demand was futile because all of the directors were named as defendants and that each had participated in the misconduct. The complaint also alleged that the defendant director dominated and controlled the board, and the directors would have to sue themselves if they assumed control of the action.[107]

In overruling the Court of Chancery's decision, the high court formulated a two-part analysis to determine whether or not to waive demand.[108] The court decided that the allegations on which the trial court based its decision to excuse demand were conclusory. Drawing inferences from these allegations had the effect of eviscerating the demand requirement.[109] Instead, the supreme court proposed a different approach to determine demand futility:

> [T]he Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof.[110]

In the first step of the inquiry, regarding the directors' objectivity and independence, the court reviews the factual background of the charges to see if there is a reasonable doubt that the directors are entitled to the protections of the business judgment rule.[111] However, it requires more than the threat of personal liability to challenge successfully the directors' independence and good faith;[112] there must be specific factual allegations of domination and control of the board by the wrongdoers.[113] If the directors fail to pass this first step, demand is excused.

At the second level of inquiry, the court scrutinizes the substantive nature of the transaction in question against the factual background alleged by the plaintiff. While the court does not assume that the transaction is wrongful, the plaintiff need only allege facts which, if

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[106]Lewis v. Aronson, 466 A.2d 375, 381 (Del. Ch. 1983), *rev'd*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[107]Aronson v. Lewis, 473 A.2d 805, 808-09 (Del. 1984).

[108]*Id.* at 814.

[109]*Id.*

[110]*Id.*

[111]*Id.*

[112]*Id.* at 815.

[113]*Id.* at 816.

true, raise a reasonable doubt that the challenged transaction resulted from a legitimate exercise of business judgment.[114] If such a question is raised, the court will excuse demand. In the case before it, the court rejected the plaintiff's arguments that demand was futile and concluded that the plaintiff had failed to allege facts with enough particularity to raise a reasonable doubt concerning the applicability of the business judgment rule.[115]

The *Aronson* court's test incorporates techniques used previously by courts to analyze the demand procedure and adds a new twist, the application of the business judgment rule to determine the preliminary issue of futility of demand.[116] First, the court requires the plaintiff to allege, with particularity, facts concerning the independence of the board and the nature of the challenged transaction. This requirement is analogous to the rule of *In re Kauffman Mutual Fund Actions*.[117] However, the *Kauffman* rule concerned the question of directors' capability to perform their duties to the corporation;[118] the *Aronson* rule extends this requirement of detailed allegations to the substantive nature of the activity in contention.[119] Second, the *Aronson* court considered the entire review of the demand issue to be factual in nature.[120] This approach is comparable to that taken by the court in *Lewis v. Curtis*,[121] where the decision to excuse demand involved a factual examination of the independence of the board of directors. Significantly, however, the *Aronson* analysis extends beyond the scrutiny of the conduct to the merits of the claim.[122]

It is the application of the business judgment rule at this point in the litigation that presents a new facet of the demand issue. While it has been asserted that the same standard should be used to excuse demand as is used to allow assertion of the business judgment rule,[123] the typical analysis has reserved determination of whether the directors' activities were entitled to deference under the business judgment rule to later stages of the litigation.[124] Usually, application of the appropriateness of the business judgment rule occurs when the board of directors moves for dismissal of the derivative suit, either after refusal of demand or after review of the allegations in a demand excused situation. However,

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[114]*Id.* at 814-15.

[115]*Id.* at 818.

[116]*Id.* at 814.

[117]479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

[118]479 F.2d at 263.

[119]473 A.2d at 814.

[120]*Id.* at 815.

[121]671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982).

[122]473 A.2d at 814.

[123]671 F.2d at 785.

[124]*E.g.*, Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983).

instead of deciding the demand question by analyzing only whether the board is sufficiently independent to make an objective decision whether to pursue the litigation on its own, a court using the *Aronson* test must probe the substance of the claims before deciding this preliminary issue.[125]

Under the *Aronson* test,[126] a dissident shareholder can obtain a preliminary review of the substance of his claims merely by pleading facts of enough specificity to raise only a reasonable doubt concerning the directors' exercise of valid business judgment.[127] As the court noted, the reasonable doubt standard places a heavier burden on the plaintiff than does the "reasonable inference" requirement of the trial court.[128] However, the reasonable doubt standard, which is analogous to the level of proof required of criminal defendants, is not particularly onerous, and any shareholder with a remotely plausible claim should be able to plead sufficient facts to raise a reasonable doubt that the directors were independent and the activity in question was a valid exercise of business judgment.

The Delaware Supreme Court applied the *Aronson* rule in a subsequent decision and declined to excuse demand.[129] In analyzing the facts contained in the complaint, the court concluded that the allegations were insufficient to raise a reasonable doubt about either the independence of the board or the exercise of business judgment in the challenged actions.[130] The court emphasized that the plaintiff had the burden of alleging specific facts that demonstrated improper conduct by the board.[131] Along with the requirement that the plaintiff make specific allegations, the reasonable doubt standard was intended to strike a balance between avoiding abuses of the derivative action and compelling a complainant to plead evidence without conducting discovery.[132] This case was submitted to the supreme court before the *Aronson* decision was announced: but in subsequent proceedings, plaintiff shareholders should have less difficulty framing complaints of sufficient specificity to raise the necessary reasonable doubt.

As a result of these rulings, if the defendants are not permitted to present any evidence to counter the allegations, the plaintiff shareholder will be virtually certain of obtaining a waiver of demand by filing a sufficiently detailed, but possibly self-serving, complaint. On the other hand, if the defendants are allowed to present evidence concerning substantive aspects of the claim, the procedure resembles a trial on the

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[125]473 A.2d at 814-15.

[126]*See supra* text accompanying notes 104-22.

[127]473 A.2d at 814.

[128]*Id.*

[129]Pogostin v. Rice, 480 A.2d 619 (Del. 1984). *See also* Kaufman v. Belmont, 479 A.2d 282 (Del. Ch. 1984) (application of *Aronson* test led to dismissal).

[130]Pogostin v. Rice, 480 A.2d 619, 625-26 (Del. 1984).

[131]*Id.* at 627.

[132]*Id.* at 625.

merits, which is an unnecessarily complex means to ascertain whether the appropriate methods have been used to initiate the suit.

While the *Aronson* court made a commendable attempt to create guidelines for determining demand futility, the probable result will be a further prolonging of derivative litigation. The addition of a court hearing on the substantive aspects of a case to determine if the preliminary procedural demand requirement should be waived unduly complicates a process that is already far from simple. Excusing demand is necessary in certain situations of blatant director misconduct, but analysis of the substantive basis of the complaint is more appropriate after demand has been made and refused and the board moves for dismissal or summary judgment. Consequently, the court may be required to engage in two factual examinations of a derivative suit before trial: one to determine if demand should be excused and another to evaluate the board's motion to dismiss after conducting an investigation of the allegations.

The decision regarding the excuse of demand and the grant of a board's motion to dismiss a derivative suit should be distinguished. The first involves a determination of the independence and good faith of the directors and whether they can be expected to pursue a legitimate shareholder claim on behalf of the corporation. The second involves a determination of whether or not the board or its litigation committee has conducted an honest and fair investigation into the claims and whether the court should grant the motion to dismiss or the motion for summary judgment. While the autonomy and good faith of the directors are crucial aspects of both issues, the more substantive scrutiny of the allegations belongs in the analysis of the second issue, consideration of a motion to dismiss.

IV. Directors' Declining Control of Decisions to Terminate

A. Background

Although the demand requirement and dismissal motions are separate aspects of shareholder derivative actions, they have certain factors in common and are often procedurally intertwined. A court ruling on the demand requirement occurs when the defendants in a derivative suit move for dismissal because of the plaintiff's failure to make a demand before filing the complaint.[133] If demand is made and refused or if demand is excused, the directors or the litigation committee may move for dismissal or for summary judgment after an investigation of the

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[133]*E.g.*, Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983); Nussbacher v. Continental Illinois Bank & Trust Co., 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976); *In re* Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); Mills v. Esmark, Inc., 91 F.R.D. 70 (N.D. Ill. 1981); Zilker v. Klein, 510 F. Supp. 1070 (N.D. Ill. 1981); Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

claims and a determination that the suit is not in the corporation's best interests.[134]

When the board or an authorized special litigation committee seeks dismissal of a derivative suit because pursuit of the claims would not be in the corporation's best interests, the court first scrutinizes the board or litigation committee's independence and objectivity and examines the extent and method of the investigation conducted to reach this conclusion. Historically, if the court found that the decision to seek dismissal was reached in good faith, after a thorough investigation of the charges and without domination by those involved in the alleged wrongdoing, the court applied the business judgment rule and deferred to the corporation's determination that dismissal of the suit was appropriate.[135] Then, in 1981, the Delaware Supreme Court announced that its scrutiny of dismissal motions in demand excused cases would extend beyond the independence and good faith of the directors and would delve into the substance of the allegations by the excercise of the court's own business judgment.[136]

B. Zapata Corp. v. Maldonado

In 1981, the Delaware Supreme Court announced the *Zapata Corp. v. Maldonado*[137] decision which created a new framework of review for dismissal motions in demand excused derivative suits and which had a profound effect on subsequent court rulings on dismissal motions. The *Zapata* litigation originated when a shareholder charged that the Zapata Corporation's directors had breached their fiduciary duties to the corporation by accelerating the exercise date of certain Zapata stock options. The Delaware Supreme Court reversed the Court of Chancery's holding that a shareholder has an independent, absolute right to pursue a derivative

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[134]Hasan v. CleveTrust Realty Investors, 729 F.2d 372 (6th Cir. 1984); Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); *In re* Continental Illinois Securities Litigation, 572 F. Supp. 928 (N.D. Ill. 1983); Abella v. Universal Leaf Tobacco Co., Inc., 546 F. Supp. 795 (E.D. Va. 1982); Mills v. Esmark, Inc., 544 F. Supp. 1275 (N.D. Ill. 1982); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[135]Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

But see Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980). In *Galef*, a demand required case, the court remarked that if the directors approved or were implicated in the challenged transaction, the business judgment rule would not necessarily apply to a decision regarding the grant of a dismissal motion. Demand was required so that the directors would have an opportunity to pursue the claim, but not to refuse it. *Id.* at 59. The case was remanded for a determination of Ohio state law on the availability of a business judgment summary dismissal. *Id.* at 62.

[136]Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[137]*Id.*

claim and that the business judgment rule does not confer power to end a derivative suit on a board of directors.[138] The higher court ruled that the shareholder's right to pursue an action terminated and that the business judgment rule would apply where demand was required and refused, but that the right to sue existed where demand was excused.[139] "Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful."[140]

It is in the demand excused situation that the *Zapata* court broke new ground. The court found that in that situation, the motion to dismiss should contain a thorough written record of the findings and recommendations and each side should have the opportunity to make a record on the motion.[141] The court applied a two-step test to the dismissal motion:

> First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.
>
> The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. . . . The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.[142]

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[138]Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[139]473 A.2d at 784.

[140]*Id.* (footnote and citations omitted).

[141]*Id.* at 788.

[142]*Id.* at 788-89 (footnotes omitted).

In reaching this conclusion, the court emphasized the realities of a demand excused situation. Where circumstances are such that demand on the board would be futile, it is less likely that even an independent committee could be completely objective.[143] Consequently, the court should try to strike a balance between complete deference to the independent judgment of a litigation committee and total control of the litigation by a plaintiff shareholder.[144]

The *Zapata* approach has been viewed as providing a balance between the corporation's desire to dispose of meritless, harmful, or costly suits and the shareholders' legitimate interest in making directors accountable for their wrongful conduct. However, the *Zapata* test gives courts broad discretion to analyze the merits of directors' actions and diminishes the effectiveness of the business judgment rule as a defense in demand excused cases. Under this approach, if an independent board or litigation committee reaches a good faith conclusion that the suit should be terminated, that decision is subject to a substantive review by the court.[145] As a result, the primary effect of the *Zapata* ruling has been a precipitous decline in the application of the business judgment rule in demand excused cases and a correspondingly sharp increase in the courts' exercise of their own business judgments to determine whether or not to grant a motion to dismiss a derivative suit.[146] Most of these subsequent cases have been excused demand situations,[147] where the courts have conducted extensive reviews of the good faith and disinterestedness of the directors as well as the substantive aspects of the decision to terminate the litigation. As a result, the procedure now resembles a trial on the merits rather than a determination that there are sufficient allegations and evidence to have a trial.[148]

C. *The Aftermath of* Zapata

The Second Circuit Court of Appeals initially adhered to the distinction between demand required and demand excused cases and followed the *Zapata* ruling. In *Abramowitz v. Posner*,[149] demand was required and the court ruled that, under Delaware law, it must defer to the business judgment of the directors who had acted independently and in good faith. On the same day, the Second Circuit decided *Maldonado*

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[143]*Id.* at 787.

[144]*Id.* at 788.

[145]*Id.* at 788-89.

[146]*See, e.g.*, Lewis v. Curtis, 671 F.2d 779 (3d Cir.), *cert. denied*, 103 S. Ct. 176 (1982); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982); Watts v. Des Moines Register and Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981); Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[147]*See supra* note 146.

[148]Kaplan v. Wyatt, No. 6361, slip op. (Del. Ch. June 21, 1983) (criticizes *Zapata* for setting up litigation within litigation and imposing substantial burdens on the trial court hearing a derivative case, while not accelerating the course of the litigation).

[149]672 F.2d 1025 (2d Cir. 1982).

v. Flynn,[150] a demand excused case, and again applied the *Zapata* test. Because demand was excused, the court had to exercise its own business judgment in reviewing a motion to dismiss. Subsequent rulings, however, have offered a variety of interpretations of the scope of the *Zapata* test.[151]

Joy v. North[152] demonstrates the extent to which the judiciary has embraced the *Zapata* analysis. A shareholder brought suit on behalf of Citytrust Bancorp, Inc. for breach of trust and fiduciary duties. The defendants were a subsidiary of the corporation and various officers and directors. The charges involved a defaulted loan allegedly in excess of the size permitted by federal law.[153] Demand was made and refused in 1977. Subsequently, in 1979, the board appointed an independent special litigation committee to investigate the allegations. The committee, after investigation, recommended that the suit be discontinued against twenty-three outside defendants and that a settlement be considered with regard to seven defendants. Following this recommendation, the corporation filed a motion to dismiss the action against the twenty-three outside defendants.[154]

The district court granted summary judgment for the defendants and held that the business judgment rule limited judicial examination of the corporation's recommendations to the independence, good faith, and thoroughness of the committee's investigation.[155] The appellate court disagreed and conducted an extensive review of the substance of the allegations before denying dismissal. The court dispensed with the demand requirement by ruling that, even though demand was made and refused, demand would not have been required because the directors were defendants.[156] The appointment of the litigation committee by defendant directors created a conflict of interest which made the business judgment rule inapplicable to the decisions of the board or its litigation committee.[157] The court, applying the *Zapata* test, not only analyzed the committee's autonomy, good faith, and the thoroughness of its investigation but also exercised the court's own business judgment concerning the recommendation to terminate the litigation.[158]

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[150]671 F.2d 729 (2d Cir. 1982). This suit involved the same parties as *Zapata Corp. v. Maldonado*. The appellate court remanded the case to the district court on the basis of the *Zapata* ruling so that the district court could apply its own business judgment.

[151]Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983); *In re* Continental Illinois Securities Litigation, 572 F. Supp. 928 (N.D. Ill. 1983); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982).

[152]692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

[153]692 F.2d at 882.

[154]*Id.* at 883-84.

[155]*Id.* at 884.

[156]*Id.* at 887-88 & 888 n.7.

[157]*Id.* at 888.

[158]*Id.* at 891.

The court made an attempt to limit the scope of this rule to those allegations involving economic injury to the corporation as a result of self-dealing, fraud, or mismanagement.[159] However, the limitation was so broad that it encompassed virtually the entire range of claims asserted in derivative actions; derivative suits typically involve allegations of self-dealing, fraud, mismanagement, or waste of corporate assets.[160]

This ruling exemplifies the extent to which courts have interceded in the resolution of disputes between shareholders and directors. If the board is implicated in the suit by the allegations in the complaint, the corporation will have little contol over the decision to terminate the suit even if a group of independent directors reaches that decision. For example, the *Zapata* court permitted a tainted board of directors to delegate its authority to an autonomous committee.[161] Conversely, the *Joy v. North* court maintained that an implicated board could not eliminate its conflict of interest by appointing an independent committee to investigate the charges.[162] This ruling, if widely followed, would essentially eliminate the use of the special litigation committee and thereby restrict the use of the business judgment rule to occasions in which the directors were not the subject of the allegations.[163]

In contrast, in *Abella v. Universal Leaf Tobacco Co., Inc.*,[164] the court, in granting a motion to dismiss, engaged in its own business analysis but less extensively than in *Zapata Corp. v. Maldonado*[165] or *Joy v. North*.[166] There was no discussion of the demand requirement

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[159]*Id.*

[160]*E.g.*, *In re* Continental Illinois Securities Litigation, 732 F.2d 1302 (7th Cir. 1984) (fraud); Hasan v. CleveTrust Realty Investors, 729 F.2d 372 (6th Cir. 1984) (self-dealing); Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983) (securitites fraud and self-dealing); Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982) (fraud); Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) (mismanagement and waste of corporate assets); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980) (self-dealing); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (corporate waste and mismanagement); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979) (mismanagement, waste of corporate assets, and fraud); Mills v. Esmark, Inc., 573 F. Supp. 169 (N.D. Ill. 1983) (waste of corporate assets); Abella v. Universal Leaf Tobacco Co., 546 F. Supp. 795 (E.D. Va. 1982) (fraud); Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (mismanagement and waste of corporate assets); Maldonado v. Flynn, 417 A.2d 378 (Del. Ch. 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (self-dealing).

[161]Zapata Corp. v. Maldonado, 430 A.2d 779, 786-87 (Del. 1981).

[162]692 F.2d at 888.

[163]*Cf.* Lewis v. Graves, 701 F.2d 245, 249 (2d Cir. 1983). (court expressing a concern that by naming all the directors as defendants the plaintiff could avoid the demand requirement). *See supra* text accompanying note 86.

[164]546 F. Supp. 795 (E.D. Va. 1982).

[165]430 A.2d 779 (Del. 1981).

[166]692 F.2d 880 (2d Cir. 1982).

before the application of the *Zapata* test.[167] The court reasoned that its exercise of business judgment should not be an invasion of the corporation's own business discretion. Rather, the court would apply its business judgment only to the extent needed to determine whether the suit would fail if continued.[168] By employing this type of scrutiny, the court tried to balance the danger of unwarranted litigation against the risk that the litigation committee would not pursue valid claims.[169]

D. Recent Applications of the Zapata *Standard*

Two cases from the Northern District of Illinois illustrate the variety of approaches courts have taken since *Zapata*. In *Mills v. Esmark, Inc.*,[170] demand was excused for charges added in an amended complaint because the corporation had refused demand on a prior complaint in the same litigation.[171] However, because demand had been excused, the court applied the *Zapata* test and examined the substantive allegations of the plaintiffs. After reviewing the merits, the court concluded that the defendants had met the burden of showing the good faith, independence, and thoroughness of the committee's investigation and that the plaintiffs had not demonstrated why deference to the committee's decision would violate the spirit of the business judgment rule.[172]

This substantive review of the allegations in the complaint, while within the scope of the *Zapata* test, served only to complicate the *Mills* litigation. Application of the second step of the *Zapata* test is an option within the court's discretion and need not be applied in every demand excused situation.[173] In the *Mills* case, neither the court nor the plaintiffs challenged the independence and good faith of the litigation committee's report.[174] The plaintiffs challenged only the committee's recommendation.[175] When demand was excused only because it had already been refused once in the same case and when not even the plaintiff could impugn the good faith and thoroughness of the committee's investigation, a review of the defendant's substantive evaluation of the claims accomplished little. Furthermore, the court proceeded to find that the plaintiffs did not adequately represent the shareholders and remarked that it would

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[167]Because waiver of the demand requirement is a prerequisite to the application of the *Zapata* test, the court's analysis would have been more persuasive if it had mentioned the resolution of the demand issue. In an earlier ruling on the *Abella* case, the court noted that no demand had been made, but that its absence was not challenged. 495 F. Supp. 713, 717-18 (E.D. Va. 1980).

[168]546 F. Supp. at 802.

[169]*Id.* at 799.

[170]573 F. Supp. 169, 172 (N.D. Ill. 1983).

[171]*Id.*; *see also supra* text accompanying notes 98-102.

[172]573 F. Supp. at 175.

[173]Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981).

[174]573 F. Supp. at 172-73.

[175]*Id.* at 173.

have dismissed the suit even if the committee report had been wrongful.[176] Thus, the court could have dismissed the suit by applying only the first step of the *Zapata* test or by ruling on the representation issue. The application of the second step of the *Zapata* test was superfluous. Although the court ostensibly applied the second step of the *Zapata* test, its decision rested on a determination that Esmark had passed the first step, proving its independence in conducting a complete, unbiased investigation of the allegations. Thus, the *Zapata* test was reduced to a meaningless exercise.

In re Continental Illinois Securities Litigation[177] exhibits yet another interpretation of the *Zapata* approach to dismissal motions. The derivative claims arose from the substantial losses Continental Illinois National Bank incurred as a result of its relationship with Penn Square Bank of Oklahoma City.[178] Demand had been properly made and refused and a special litigation committee determined that pursuit of the litigation was not in Continental's best interests. The parties agreed that Delaware law applied and that *Zapata Corp. v. Maldonado*[179] was the controlling case. The parties disagreed over the appropriate level of inquiry the court should use in reviewing the committee's decision.[180] The district court broadly interpreted *Zapata* to apply to demand required cases as well as demand excused cases. Reasoning that the discussion of distinctions between excused demand and required demand was not pertinent to the issue in the *Continental* case, the court said:

> The fact that there was no demand in *Zapata*, and that the court regarded the case as one where the demand was excused, is not a significant distinction, because in *Zapata*, as here, the question is what effect is to be given the corporate decision recommended by directors who are not alleged to have participated in the wrongdoing.[181]

The *Continental* court, relying on a passage in *Zapata*, questioned whether it was appropriate to accept the business judgment of a litigation committee " 'at this stage of derivative litigation.' "[182] The phrase was interpreted to refer to "the stage of legal development our society has reached."[183] However, the *Zapata* opinion had proceeded to emphasize that the context was a demand excused case: "We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case."[184] Even though the *Zapata* decision extended the scope of review of motions to dismiss derivative actions, that opinion,

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[176]*Id.*
[177]572 F. Supp. 928 (N.D. Ill. 1983).
[178]Wall St. J., July 11, 1984, at 8, col. 1.
[179]430 A.2d 779 (Del. 1981).
[180]572 F. Supp. at 929.
[181]*Id.* at 930.
[182]*Id.* (quoting Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981)).
[183]572 F. Supp. at 930.
[184]430 A.2d at 787.

when read as a whole, does not expand this level of scrutiny to demand required situations.

The *Continental* court also interpreted *Zapata* to reject deference to the business judgment of a special litigation committee.[185] Under this interpretation, *Zapata* rejected the conclusions of other courts that the sole issue was the independence, good faith, and thoroughness of the committee's investigation.[186] However, the *Zapata* court was careful to explain that even a tainted board of directors could delegate to a special litigation committee all of the board's power to terminate a derivative suit.[187] The decision to terminate a derivative action where demand has been made would be respected unless it were wrongful.[188] The *Zapata* opinion went on to distinguish the demand excused case before it from the typical demand refused case and applied the two-stage analysis to the dismissal motion.[189] By deciding to apply both levels of the *Zapata* test, the *Continental* court failed to consider *Zapata*'s interpretation of Delaware law that a board can delegate full authority to a litigation committee to terminate a derivative suit and that the court should respect a committee's decision to terminate such a suit where demand is made and refused unless the decision was wrongful.

The *Continental* court proceeded to apply the *Zapata* test to the committee's recommendations. The first step was an inquiry into the independence and good faith of the committee and the bases for its conclusions. The affidavit submitted by the committee described the procedures used but failed to disclose the facts revealed by the investigation. Because these facts were not disclosed, the court decided it could not adequately evaluate the committee's investigative procedures, denied the dismissal motion, and ruled that there should be a limited evidentiary hearing at which the defendants would present their case for dismissal.[190] The court intimated that after the defendants presented their evidence, it would decide whether any further discovery was needed by the plaintiffs.[191] While this proceeding was intended to address only the issue of the independence of the litigation committee and the thoroughness of its investigation, such an open-ended evidentiary hearing resembles a trial on the merits of the claims.

Moreover, even if the defendants passed the first step of the inquiry, the court observed that it still had the discretion to apply the second step, its own business judgment.[192] Presumably, application of this step would require another evidentiary hearing, further prolonging the pretrial process.

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[185]572 F. Supp. at 929-30.
[186]*Id.* at 930.
[187]430 A.2d at 785-86.
[188]*Id.* at 785.
[189]*Id.* at 787-89.
[190]572 F. Supp. at 930-31.
[191]*Id.*
[192]*Id.*

The *Continental* court's reading of *Zapata* is among the most expansive interpretations of that case and provoked a sharp dissent in an appeal on a collateral issue in the *Continental* litigation.[193] Circuit Judge Wilbur F. Pell, Jr., argued that the district court had misread *Zapata* and should have confined its review to the committee's independence and objectivity in reaching a good faith business decision not to pursue the action.[194] The judge interpreted *Zapata* to say:

> that it was already firmly established in Delaware law that the business judgment prevailed in the demand case but that in the case in which the stockholders proceeded to file a derivative suit without making a demand first on the corporation to take action that a second step resting in the independent discretion of the judiciary was necessary.[195]

If the district court had treated the issue as a demand required case, it would, according to Judge Pell, have found that the investigation was properly conducted by an independent committee and would have terminated the suit.[196] To date, the *Continental* district court's broad interpretation of *Zapata* has not been followed elsewhere, but the decision serves as an example of the extent to which an activist court can interject its substantive judgment into the preliminary stages of a shareholder derivative suit.

V. Implications of the Exercise of Judicial Business Judgment

Objections to this weakening of the business judgment rule revolve around the issue of judicial ability to make competent business decisions. As Judge Cardamone stated in his dissent in *Joy v. North*,[197] "It is a truism that judges *really* are not equipped either by training or experience to make business judgments because such judgments are intuitive, geared

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[193]*In re* Continental Illinois Securities Litigation, 732 F.2d 1302 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part). The district court had ordered Continental to produce copies of the litigation committee's report for a hearing on the merits of the motion to dismiss. *See* 572 F. Supp. 928 (N.D. Ill. 1983) and the discussion accompanying *supra* notes 177-192. The order requiring production of the report expressly preserved claims of privilege and work product associated with the report. 732 F.2d at 1305 n.4. However, the report was discussed in court during the hearing on the dismissal motion. *Id.* at 1305-06. After Continental withdrew its motion to terminate claims against certain defendants in order to avoid a further review of the merits, reporters sought access to the committee's report. The district court judge ordered the release of the report to the press and Continental appealed. *Id.* The appellate court affirmed the decision on the issue of the effectiveness of the protective order and declined to consider the district court's interpretation of *Zapata*. Continental had failed to appeal the decision regarding the appropriate standard for ruling on the dismissal motion. *Id.* at 1309 & 1309 n.12.

[194]*In re* Contintental Illinois Securities Litigation, 732 F.2d 1302, 1320 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part).

[195]*Id.* at 1319.

[196]*Id.* at 1317.

[197]692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

to risk-taking and often reliant on shifting competitive and market criteria."[198] It is difficult for courts to formulate workable criteria for evaluating substantive business decisons which involve a multitude of factors encompassing risk balancing, changing market conditions, and intuition.[199] Determining which of the factors to consider and evaluating the weight to give each factor present serious problems for a court to overcome.

Similarly, judges do not have the training or experience necessary to make sound business judgments.[200] Business decisions are entrepreneurial in nature and involve weighing the risks of loss against the potential for profit. Judicial decisions concern the application of legal principles to particular facts. Judicial participation in substantive business decisions leads to greater uncertainty for both the corporation and the aggrieved shareholders; neither side can predict on what basis the court will reach its decision and valuable resources are wasted in prolonged litigation.

These concerns are especially apparent in derivative suits where the factual issues are complex and a business judgment by one unfamiliar with the particular business has a high possibility of error. Thus, the potential benefits of an exercise of judicial business judgment to pretrial rulings on demand excusal and dismissal motions will seldom outweigh the problems that can result from a court's erroneous application of business judgment.

Nevertheless, dissident shareholders in meritorious derivative actions have significant, legitimate concerns. There is a tendency for a board of directors to develop an esprit de corps and a defensive attitude toward those who attack its judgment.[201] The judicial system can protect shareholders from this tendency by carefully scrutinizing the independence and good faith of the directors or litigation committee. The business judgment rule has consistently applied only to decisions made in good faith; if the directors acted wrongfully, they were not entitled to the rule's protections.

VI. An Alternative to Judicial Business Judgment

Emphasis on the objectivity of the directors rather than the merits of the challenged transaction affects judicial decisions about both the

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[198]692 F.2d 880, 898 (Cardamone, C.J., concurring in part and dissenting in part) (citation omitted).

[199]*Id.* (citing Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979)).

[200]*See, e.g.*, *In re* Continental Illinois Securities Litigation, 732 F.2d 1302, 1319-20 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part) (Pell questioned the judge's business judgment in reviewing the adequacy of the litigation committee's report. According to Judge Pell, the trial judge had stated that he "knew nothing about Price-Waterhouse other than what I have heard here.").

[201]Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 377 (6th Cir. 1984) (quoting Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Colum. L. Rev. 261, 283 (1981)).

demand requirement and dismissal motions. If circumstances demonstrate that the board or litigation committee has acted in bad faith or has an inherent conflict of interest, demand will be excused as futile. Likewise, if the court perceives that, for any reason, the directors or litigation committee has not made a scrupulous, good faith investigation of the allegations before recommending dismissal, the litigation should not be terminated.

Before the *Zapata* decision and the trend toward increased judicial involvement in derivative suits, courts routinely deferred to the directors' decision to terminate these actions. Courts were reluctant to interfere with the directors' business judgment concerning the derivative claims unless there was a showing that the determination was wrongful. Because derivative suits were brought on behalf of the corporation, not the shareholders as individuals, the corporation, if acting in good faith, was permitted to control the course of the litigation. The corporation was the party most directly concerned with the results of such litigation and, therefore, in the best position to determine whether or not pursuit of the claims would further the corporation's interests.[202]

As shareholders became more willing to assert derivative claims, courts began scrutinizing more closely the directors' decisions to terminate these suits. The courts moved from examining the process by which the decision to terminate was reached to evaluating the substance of the decision itself. There was a legitimate concern that the directors be accountable to shareholders and the corporation when their conduct was wrongful or when the directors breached their fiduciary duties to the corporation.

However, holding directors accountable for a decision that is wrong, if based on good faith business judgment, cripples the board's ability to manage the corporation effectively and places the judiciary in the awkward position of ruling on corporate business decisions. This situation does not protect shareholders' interests in having the corporation managed competently and efficiently. Nevertheless, judicial scrutiny of the good faith and independence of the board of directors does further the shareholders' concern that the elected directors act in the best interests of the corporation, not for their own enrichment.

The Federal Rules of Civil Procedure require a demand on the board unless the challenger can show why demand would be futile.[203] The burden of proof should fall on the party seeking to avoid demand to establish that demand would be futile. If the challenger fails to meet this burden, he must make a demand before proceeding with the suit; the plaintiff is not necessarily precluded from seeking a remedy even if the required demand is rejected by the corporation. If the directors refuse the shareholder's demand to pursue the claim, the shareholder can file the derivative suit which will proceed as would any litigation.

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[202]*See supra* text accompanying notes 54-64.

[203]FED. R. CIV. P. 23.1.

Moreover, if the directors agree to assert the corporation's claims directly, the derivative litigation can be avoided entirely.[204] Consequently, no benefit accrues from examining the merits of the suit at this preliminary proceeding.

The situation changes after demand is excused or made and subsequently refused. When the corporation moves for dismissal, it has the burden of proving that the litigation should not go to trial. The corporation must demonstrate that it acted independently and in good faith in deciding to terminate the suit.[205] The burden on the corporation is more difficult to sustain when demand has previously been excused for futility than when demand has been made and refused. Where there has already been a finding that the directors were prejudiced enough to warrant waiving the demand requirement, any contention that that board or its duly appointed litigation committee has conducted a thorough and unbiased investigation must be viewed with skepticism. However, in both demand required and demand excused cases, if it is determined that a group of truly independent and objective directors based its decision to end the suit on a complete and fair examination of the allegations, a reexamination of the merits by the court accomplishes little except to prolong and complicate the litigation.

To permit judges to apply their own business judgment, especially when demand was not excused because the board or litigation committee was deemed independent and honest, reduces the vitality of the business judgment rule; in few instances will the courts defer to the corporation's business discretion. When demand is excused as futile, there is a compelling reason for the court to be wary of deferring too readily to the corporation's judgment. The concern about the objectivity of the directors may offset the concern about the competence of the court's business judgment. However, if it is determined that demand should not be waived, and that the board or litigation committee is independent and operating in good faith, no additional benefit accrues from another examination of the merits by the court.

VII. Conclusion

By exercising judicial business judgment on the merits of a derivative action, courts have attempted to balance the rights of shareholders to seek redress for corporate misconduct against the right of the corporation to conduct its legitimate business freely. The derivative action does provide shareholders a remedy when intracorporate procedures have failed. However, it is inescapable that many derivative suits are of questionable merit, brought for the purpose of obtaining quick settlements

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[204]Kaufman v. Safeguard Scientifics, Inc., 587 F. Supp. 486 (E.D. Pa. 1984).

[205]Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 377 (6th Cir. 1984); Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982); Abramowitz v. Posner, 672 F.2d 1025, 1031 (2d Cir. 1982); Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

and hefty attorneys' fees.[206] The business judgment rule affords directors the opportunity to dispose expeditiously of this meritless litigation.

The Delaware courts have interjected their own business judgment at two stages of the derivative suit. First, to decide whether or not to waive the demand requirement, the court examines the substantive aspect of the challenged transaction to determine if it resulted from the legitimate use of business discretion.[207] Second, in demand excused situations, the court again employs its own business judgment to decide if it should grant a motion to dismiss.[208] This trend toward application of judicial business judgment has resulted in a corresponding trend away from deference to corporate business judgment.

It has been long established in American law that shareholders have no right to challenge in court the good faith business judgment of the board of directors.[209] By purchasing the corporation's stock, shareholders subject themselves to the normal risks of the business world. As the *Aronson v. Lewis*[210] and *Zapata Corp. v. Maldonado*[211] decisions demonstrate, the courts have, in effect, assumed the right to challenge good faith business decisions in certain shareholder derivative suits. Continuation of this trend toward judicial review of corporate affairs places corporations at the mercy of any disgruntled shareholder who can convince a court the corporation exercised imperfect judgment. Nevertheless, shareholders certainly have a right to seek redress for corporate malfeasance. A stringent review by the courts of the objectivity and independence of the directors and the means used to evaluate the shareholders' claims will protect that right without compromising the corporation's autonomy.

LUCY A. EMISON

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[206]*In re* Continental Illinois Securities Litigation, 732 F.2d 1302, 1317 (7th Cir. 1984) (Pell, J., concurring in part and dissenting in part); Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); Mills v. Esmark, Inc., 573 F. Supp. 169, 176 (N.D. Ill. 1983).

[207]Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

[208]Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981).

[209]Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341 (1855).

[210]473 A.2d 805 (Del. 1984).

[211]430 A.2d 779 (Del. 1981).

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